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ABSTRACT

One of a series, this handbook is designed to assist individuals involved in area development to gain knowledge and understanding of the public and private sources of funds for support of various area development activities. National, regional, and local private sector sources of development capital are examined to give an overview of business finance including private debt finance, the concept of operating leverage, the nature of operating debt and its cost, credit instruments, corporate debt, private equity finance, investment banking, the regulation of securities issues, the supply of new equity financing by institutional investors, specialized financial institutions, and other potential sources of private capital. Attention is accorded to local commercial banks and savings institutions, among others, as sources of development capital. Industrial development bonds, state loans and guarantees, and business development corporations are examined, along with the programs of the Small Business Administration and other public sources. Institutional devices for dealing with area development finance, such as local development corporations, community development corporations, housing development corporations, small business investment corporations, and various types of cooperatives, are referenced as vehicles to be considered both for their special purposes and as parts of a comprehensive area development finance structure. (Author/CM)

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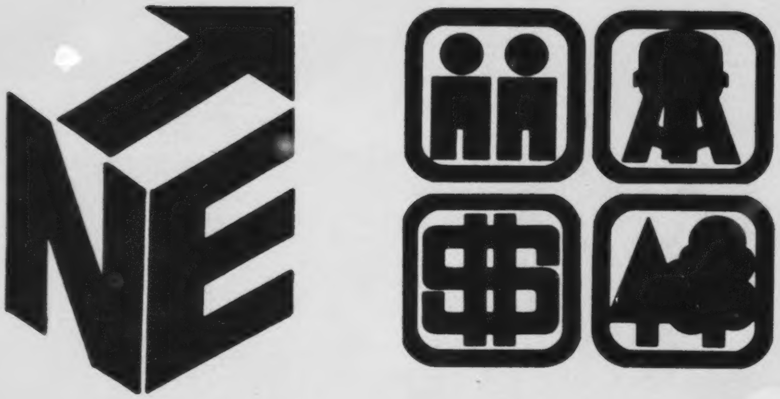

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How to finance and administer rural development programs

handbook no. 3

Northeast Regional Center for Rural
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HOW TO FINANCE AND ADMINISTER RURAL DEVELOPMENT PROGRAMS

- HOW TO TAP PUBLIC AND PRIVATE SOURCES OF FUNDS FOR SUPPORT OF VARIOUS AREA DEVELOPMENT ACTIVITIES
- HOW TO FINANCE COMMUNITY FACILITIES
- HOW TO FINANCE LOCAL BUSINESS AND STIMULATE NEW JOBS

National Area Development Institute
Post Office Box 967
Rockport, Texas 78382

Resources for Rural Development Series
Handbook No. 3
June 1977

EDITORS' INTRODUCTION

This handbook is one of a series intended to aid community leaders, Cooperative Extension agents, local government officials, change agents and others in their efforts to gain external resources needed to support local efforts in rural development. The principal aim of these handbooks is to simplify the process of locating resources, applying for them and administering those that are gained. All too often these three tasks are seen as being very complex, when in fact they can be performed by the average citizen. In this sense, these handbooks are designed to show how common sense, initiative and community effort are all that is required to tap federal, state and foundation resources. The titles of the first three handbooks illustrate the thrust of the series:

No. 1 How to Gather Information on Community Needs and Funding Sources

No. 2 How to Write Proposals for State, Federal and Private Funds

No. 3 How to Finance and Administer Rural Development Programs

All three of these handbooks are now available. From time to time, as we gain new experience and discover additional needs of communities seeking funds, we will revise these handbooks. In addition, if these handbooks find an interested audience, and if we receive requests from you for more specialized ones, we will attempt to supply them in an effort to help you meet your community and rural development needs.

The handbooks are being organized under an informal committee composed of Stephen Philip Johnson and John P. Snyder of Cooperative Extension, and John M. Cohen of Cornell's Department of Rural Sociology. A first edition of handbook no. 1 was published by Cornell University's College of Agriculture and Life Sciences. This edition proved so successful that we were able to obtain funding for the entire series from the Northeast Regional Center for Rural Development. If you wish to obtain the entire series or additional copies, you can address the Center at 242 Roberts Hall, Cornell University, Ithaca, New York 14853.

Any ideas or suggestions from those using these handbooks will be greatly appreciated. If we receive requests from you for more specialized handbooks relating to this general topic, we will try to meet them. Such comments should be addressed to either of the editors of this series:

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PREFACE

This handbook was developed by the staff of the National Area Development Institute. We are fortunate to be able to use it as the third handbook in the Northeast Regional Center for Rural Development's Resources for Rural Development Series. For further information on this handbook or on the larger programmatic efforts of NADI, you should write: P.O. Box 967, Rockport, Texas 78382.

As the title indicates, financing area development efforts is the chief focus of this handbook. Development capital for nonmetropolitan areas is needed for three broad purposes:

- To finance basic community facilities such as water and sewer systems, hospitals, roads and schools;
- To finance business location and expansion leading to the improvement of existing jobs and creation of new employment for area residents;
- To provide individual equity through provision of certain basic public services and to prevent the erosion of private assets that results from the decline of once viable communities and institutions.

Although financial resources are a prerequisite for area development in our industrialized economy, capital injection or formation alone cannot guarantee development. There must also be local and area leadership, both individual and institutional, sufficient to the task of eliciting and channeling available resources for desired developmental impacts.

Someone must provide the informed leadership necessary to the formulation and implementation of realistic area development finance programs and policies. Community financing must be a continuing concern, involving an inventory and appraisal of area resources, the determination of project demands on financial resources, and the actual raising of funds.

And, someone must provide the local technical capability to enable entrepreneurs to know when to seek credit for debt financing, where and how to obtain loans of various types, how to make the best use of borrowed money, and how to perform the proper accounting and reporting procedures. At the same time, a technical capability is needed to enable small community financial institutions to evaluate their investments in terms of the development impact of the local loan, as well as in terms of the credit institution's prospects for receiving a fair return on its investments.

Similarly, local governmental entities need expertise in "municipal" bonds and the process, purposes, procedures, and legalities of public debt finance. And, private entrepreneurs need to have an understanding of equity finance principles and procedures, including the ways they might access various capital markets. Although community leaders generally will be aware of the local resources they have to draw on, they are not likely to be fully cognizant of other resources available from outside of the community. A knowledge of State and Federal grant, loan, and guarantee programs and external private sector credit and equity investment sources can be extremely valuable in placing a community and its area in a more competitive position to develop a desirable quality of life for its people.

Financing business projects is complex, not only because of the various courses open to action, but also because of the differing nature and needs of each business prospect. The community offering the broadest range of financial services and expertise to business will have a distinct advantage over other communities not so well prepared. A major consideration that always must be taken into account is how the community and its areawide environs may appear to an outside investor. Businesses will evaluate the community in light of establishing some new economic enterprise. For communities to be successful in attracting such business operations, local citizens must recognize those values which investors look for in every community and understand how their community may measure up to the investor's standards for his particular project. For one, the local financial climate influences investor attitudes.

Area banks and other financial institutions have a major interest in the growth of local communities, since such growth will lead to the expansion of their own business. A number of large banks now have officials whose main concern is economic development of the service area, and even small financial institutions are to some degree aware of benefits that might accrue from work in this field. Cooperation can vary, however, and some examination and appraisal should be made as to the progressive, developmental attitude of local financial establishments. Advance knowledge of the extent to which local funds may be available from the private financial sector to support any economic development program in the community can be extremely valuable. But, no fixed financial potential can be established as a guide in assessing that community resource, since loan limitations for banking institutions vary greatly and are influenced by State and Federal regulations, seasonal demand and individual loan policies.

Any thorough examination of resources for community development must include those sources of capital which are generally available for commerce and industry. Many small new companies and existing businesses are unsuccessful in finding outside financial help for new ventures or expansion of existing facilities. Inability to obtain loans from conventional lenders many times is based upon sound reasons advanced by the lending institutions. Many lenders do not have the legal capacity or lendable funds available to assist a worthy small business. Others may not feel that they can accept the risk exposure, the size, the term, or the return involved in such a loan, despite prospects for success and beneficial developmental impact, even though they may have the funds available.

The community which is able to provide some financing for a new branch plant, an expansion of an existing plant, or other new local enterprises is far more likely to expand its economy. The creation of employment opportunities in economically depressed areas is a difficult challenge, simply because businessmen are extremely reluctant to take the considerable risks

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involved in this type of venture. They have to have some reasonable assurance that their efforts will stand at least a 50-50 chance of success. Yet, even though they are faced with many obstacles, such as poor transportation and services, an unskilled labor force and inadequate financing, many established firms and individuals are seriously considering locating in such areas.

Community financing programs will vary from state to state, since they are controlled to some degree by state law. Often a formal development corporation is necessary if anything significant is to be accomplished. Ideally, it should be organized, chartered, funded, and ready with one or more packaged plans for financing land and buildings. But, before community spending starts, a feasibility study should be made to determine whether a particular business to be located at a specifically identified site has a reasonable chance for success.

As financial plans of a prospect for local government or development company assistance are reviewed and negotiations develop, there are a number of terms that will be dropped into the conversation that communities need to understand in order to evaluate a proposal. The most common terms are assets, liabilities, working capital, and financial statement or balance sheet.

This handbook is designed to assist individuals interested and involved in area development in gaining knowledge and understanding of the public and private sources of funds for support of various area development activities. In the sections which follow, national, regional and local private sector sources of development capital are examined in an attempt to give an overview of business finance: including private debt finance, the concept of operating leverage, the nature of operating debt and its cost, credit instruments, corporate debt, private equity finance, investment banking, the regulation of securities issues, the supply of new equity financing by institutional investors, specialized financial institutions, and other potential sources of private capital. Attention is accorded also to local commercial banks and savings institutions, among others, as sources of development capital.

In addition, industrial development bonds, State loans and guarantees and business development corporations are examined, along with the programs of the Small Business Administration and other public sources. And, institutional devices for dealing with area development finance, such as local development corporations, community development corporations, housing development corporations, small business investment corporations, and various types of cooperatives, are referenced as vehicles to be considered not only for their special purposes, but also as parts of a comprehensive area development finance structure.

The key ingredient in any viable area development finance effort is creative leadership. It is hoped that this handbook will help its readers to supply that leadership.

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PART I

NATIONAL AND REGIONAL SOURCES OF PRIVATE CAPITAL FOR BUSINESS CREATION AND EXPANSION

INTRODUCTION

PRIVATE SOURCES OF CAPITAL

Area development in the 1970's is a challenge for private sector initiative in our mixed economy. Although schools, highways, and other facilities essential for community economic development and expansion are generally purchased through government, gross private product accounts for around ninety percent of gross national product. American public policy is based on the assumption that private enterprise will be the normal means of supplying goods and services to the public. Public policy interventions are meant to be corrective and supplemental.

Most experts agree that if area development goals are to be realized, the private financial community must provide the largest part of the necessary investment capital.

The location of economic activity is still basically founded on a series of private sector decisions involving the desirability of raising business revenues and reducing business costs. Broad economic forces in the private sector are the major determinants of national-regional-local economic trends and decisions.

Some economic activities are land-oriented; some are market-oriented; some are transportation-oriented; some are energy-oriented; others are labor-oriented. All require certain compromises among significant location factors, and all require both fixed capital for goods or equipment and working capital. Geographic variations in the availability or nonavailability and the price of capital can influence the location of economic activity and consequent community economic development.

CAPITAL, ECONOMIC GROWTH AND AREA DEVELOPMENT

Although area development is more than a sustained rise in real per capita net income, full, gainful, productive employment is at its heart. Not only does such employment provide the personal income necessary to support a reasonable level of living, but also it provides the tax base with which to provide public services.

Increases in private sector production through enhanced productivity are the source of increments in real income. Increases in real income and improvements in the equity of its distribution translate into qualitative as well as quantitative aspects of economic growth, progress, or development.

Economic growth requires investment in capital goods, and thus capital formation is essential to community economic development. The complex of institutions and mechanisms that brings together the savers and investors actually engaged in capital formation is known as the capital market. In the capital market, interest or yield is a major factor. In simple terms, profit is a primary motivating force, just as in other businesses.

A characteristic of the financing of existing business is the use of funds obtained from retained earnings and depreciation allowances, but there is also a significant dependence on funds obtained by selling notes, bonds, and stock in the capital market and borrowing from financial intermediaries in the money market. In short, the private entrepreneur who is already in business generally must interact with the financial market to meet at least some of his capital requirements. But, the ease with which the expansion of an existing small business can be financed from private market sources varies with geography as well as with the firm's track record and potential.

Venture capital for the creation of a new business firm is generally considered to be "high risk" capital, with limited liquidity, which requires the potential for a relatively high return on investment. Initial financing beyond what the principal, his family, and his friends provide generally will come from selling ownership shares to venture capital companies, groups and families traditionally involved in such matters.

Venture capital can be relatively difficult to secure from traditional investment banking channels and financial institutions. However, some brokerage firms, pension funds, profit-sharing funds, trust companies, insurance companies, hedge funds, specialized mutual funds, and investment advisers, as well as wealthy individual investors and families do put some of their funds into venture capital situations.

Yet, many small town and rural area economies have not been the beneficiaries of significant venture capital investments for development from outside, nor have local savings been converted to developmental venture capital investments. Capital is the root of all economic development and the lack of local development capital is what causes economic stagnation in rural areas.

The structure and nature of the local financial community in many rural areas have deprived businesses of adequate financing. The private business credit situation has been especially bad with respect to long-term financing. Small, unincorporated firms and many small corporations are highly dependent on commercial banks for their long-term capital requirements. Moreover, they frequently must rely on personal, informal contacts rather than intermediation in more nearly perfect capital markets. Thus, while short-term financing may be adequate for most, their inability to obtain long-term financing makes it impossible for them to expand. In fact, some firms never get off the ground at all because of lack of financing.

Local banks must be judged by how well they transfer surplus community funds into actual investment projects. If this standard is applied, the efficiency of local banks is measured by relative local development loan-to-deposit ratios, rather than earnings on capital. On the other hand, local area development leadership may be evaluated at least partially on the extent of loan demand for development projects.

Capital reserve, capital storage, collection, and aggregation institutions designed to use locally generated development capital must be erected and operated to stem capital drainage and to further local economic development in most areas. Local development companies, small business investment companies, and similar institutions may be a key ingredient for area development.

BUSINESS FINANCE OVERVIEW AND BACKGROUND

A business operation can be conceptualized as a system of funds flows, i.e., a series of resource deployments for profit, based on management decisions. Viewed in their broadest sense, these decisions involve the investment of resources, the operation of the business with the help of these resources, and the proper mix of financing to provide the resources. While business has infinite variety, there is the common theme of management: directed commitments of resources for the purpose of creating, over time, sufficient economic value to recover the resources and a margin of profit beyond.

The key strategies for the conduct of operations involve the appropriate deployment of assets for serving selected markets, and the use of appropriate price and service strategies to do so effectively. The disposition of profits amounts essentially to a three-way split, each part of which is subject to current or prior management decisions and policies. The payment of dividends to owners is a matter of discretion by the board of directors, however, the degree of payout influences the possible use of profit dollars for reinvestment and growth. The payment of interest is a matter of contractual obligation, but the relative amount is a function of the financial policies toward the use of debt - the higher the debt proportion of the capital structure, the greater the demand on profit dollars for use as interest payments, given a normal return on assets. Furthermore, high debt proportions will generally require higher interest rates to compensate for potential risk to the holders. Finally, earnings retained will be the residual amount of profit available to fuel additional investment and growth, together with new capital provided by investors and lenders. Payout ratios and coverage of interest are key measures in this area.

Financing strategy represents the selection and balance of the relative proportions of ownership and debt funds to bring about an acceptable level of profitability with due regard to business risks and the obligations of debt service. The types of equity which can be employed are numerous, and the same is true of the choice of debt instruments. Here, the key concept is the impact of financial leverage. This refers to the prudent use of fixed-cost debt obligations and the investment of such funds in opportunities with potentially higher earnings than the interest obligation itself. Key measures include the ratio of debt to equity, debt service coverage, and return on equity. Investment strategy covers the whole area of capital budgeting, that is, the selection of investments to match both the operational characteristics and the objective of the business and the financial policies it deems acceptable.

OPERATING LEVERAGES

Operating leverage refers to the often favorable condition of having a stable element of cost (fixed or period cost) support a wide range of operating volume. This condition tends to magnify the profitability of the higher levels of operations, as each unit of additional output contributes a sizable margin or profit based on strictly variable costs only. Once all fixed (period) costs have been recovered by a minimum level of operations, profits rise proportionately faster than the rate of increase in volume itself. Unfortunately, a similar condition holds for declining operations, with acceleration of losses out of proportion to the rate of volume reduction. A similarity exists between operating leverage and financial leverage, since in both cases there is an opportunity to profit from the fixed nature of certain costs relative to increments of profit. In financial leverage, the advantage arises from the simple notion that funds borrowed at a fixed contracted interest rate can often be employed at an opportunity rate of return higher than the interest paid. Given a company's ability to make investments which provide returns consistently above the going rate of interest, it will be to its advantage to trade on equity. This means borrowing as much as prudent management will permit and thereby boosting the return on ownership equity by the difference between the rate of return and the interest paid.

Sources of funds for a going enterprise are numerous and varied, and the types of contracts, understandings, and arrangements can be suited in a tailor-made fashion to almost any conceivable set of circumstances. This variety is introduced, however, largely through modifications of two basic choices: debt on the one hand, and equity on the other, with a third choice, preferred equity, representing a middle ground. Debt, of course, is created through a contract which calls for eventual repayment of value committed, usually at interest; while equity is an ownership commitment, generally without termination and carrying all the risks of ownership. Preferred equity has elements of both, even though it basically is an ownership involvement. The choice of appropriate financing sources is part of the planning task of management, and is inextricably connected with the nature of the operations, the projected conditions, the industry, and the style of management. This planning task involves a matching of appropriate funds sources to the current and expected future operations and investments.

The alternative funds sources available to management involve varying degrees of risk exposure, since the proportion of debt and equity to a large extent determines the ability of a company to fulfill its obligations in periods of high and low earnings. Management, responsible to the stockholders for a fair return on their investment, must therefore spend much thought and care to determine the right mix of debt and equity in a company's capital structure - enough low-cost debt to boost the owner's return by applying debt to projects earning more than the cost of borrowing the necessary funds, and not too much debt to endanger the stockholders' return and even the company's solvency in low earnings periods. The latter point relates to the fact that fixed debt obligations must be met regardless of circumstances.

PRIVATE DEBT FINANCE

Throughout the existence of a corporation, the management makes financing decisions which result in changes in the funds sources used and quite often in changes of the capital structure itself. These range from minor modifications to possible recapitalization. Each increment of change involves an increment or decrement of cost, as well as having an effect on the cost of the total capital structure.

In the course of business an enterprise commonly employs many forms of debt, which range from trade obligations (accounts payable) to long-term mortgage loans or debenture bond issues, and which include simple notes payable to banks or individuals, tax payments owed to various governmental agencies, wages due, payments due on installment purchases, and even lease obligations. All types of debt, which include many others not mentioned, can be analyzed relatively easily as a first step by deriving the explicit cost involved for the company. Normally, debt arrangements carry specific interest provisions payable either during the debt period, at its end, or deducted in advance from principal (called discounting). The explicit cost of debt in those cases is simply the cost of this interest commitment.

Interest is tax-deductible for corporations, therefore the cost to a corporation (at least those with sufficient profits to pay taxes or able to apply tax-averaging provisions) will be the fraction of the annual interest payment multiplied by a factor of one minus the applicable tax rate. The effect of tax deductibility is a reduction of the cost of debt to corporations (and to individuals under many circumstances) to a net amount after applying the prevailing tax rate. This is in contrast to situations involving other forms of capital.

OPERATING DEBT

Some operating debt funds - short-term or revolving obligations incurred in the ordinary everyday operations of most businesses - are in fact provided free of any explicit cost, under trade terms generally accepted in the type of industry in which the company operates. Foremost in this category are accounts payable, which are incurred under many variations of terms. Up to ten or fifteen days, or even as long as forty-five days, the company being billed for goods or services can hold off payment and, without cost, can make use of the values received on credit. Trade credit is in fact a significant funds source. In most cases of trade credit, when payments are made within a specified period, it is possible to earn a discount of two percent if paid within ten days (2/10), or three percent if paid within fifteen days (3/15) from the date of the invoice. This practice allows the customer to reduce, in effect, the cost of the goods or services by the specified amount. The purpose of this inducement is to help the vendor collect his funds faster and thus to reduce his own funds tied up in accounts receivable. If the discount period is missed, however, the net amount is due by the end of the credit period specified. If the debtor company makes use of this option, a very definite cost is incurred for prolonging the time during which it can make use of the funds. This is an opportunity cost in the form of cash discounts lost. But since the corporation loses as taxable income the cash discount it would have otherwise earned, the explicit net cost must be reduced by the taxes saved. Even at this, the cost can remain a fairly sizable figure on an annual basis, as compared to the prime interest rate generally charged large corporations of impeccable credit rating.

Some companies, especially small and rapidly growing enterprises, make it a practice to use accounts payable as a convenient source of credit, often unilaterally exceeding the outside limits of credit terms by sizable periods. The longer the funds are kept, of course, the lower becomes the explicit cost of accounts payable, since normally no interest charges are levied by the trade creditor. In extreme cases, unpaid accounts may be converted to notes payable, with or without interest, upon the request of the trade creditor who wishes to establish a somewhat stronger claim. From the standpoint of credit-worthiness and company reputation, it is clearly a poor practice to go beyond the stipulated credit period, since other prospective creditors will take such tardy performance into account when they evaluate further credit extension. This aspect is part of the implicit cost of credit and other forms of capital.

Another form of operating debt is the short-term note and the installment contract, in which interest is either charged ahead of time or is added to the amount of principal stated in the contract. If the note is discounted by deducting the interest in advance, the effective cost before taxes becomes higher than the stated interest. In the case of an installment contract payable in four quarterly installments with interest on the original balance, the effective cost of interest is much higher than stated, since over the term of the contract decreasing amounts of principal are outstanding and used by the borrowing company. Over the term of the contract the principal amount drops to zero, with the average amount outstanding being roughly half of the principal, while the contractual interest becomes part of each of the four payments. When the interest paid is related to the average amount of capital in the hands of the borrowing company over the period of the loan, a doubling of cost before taxes results. If the contract runs over more than one year, care must be taken to annualize the interest cost, that is, to relate the interest amount to the specific time period involved in order to arrive at a true cost per year, which is the normal period of comparison. If more precision is required, approximate results can be refined through the use of present value techniques (time discounting). Such an approach is useful when exactness is important and where the incidence of the funds flows covers considerable time periods and a variety of patterns. Banks and other lending institutions use tables based on present value techniques to calculate with precision the charges and payments connected with contracts of this sort. However, a simple averaging technique is useful in many circumstances, including personal finance, to obtain for decision purposes a fair approximation of the true, effective, or explicit cost of contracts of this type.

COST OF OPERATING DEBTS

The explicit cost of common operational debt obligations may range from zero to quite substantial rates of interest. This explicit cost is not the only aspect of debt, however. Repayment schedules have to be met, and while there is no specific cost connected with the repayment of principal, the obligation to do so in a timely fashion forces the financial manager to forecast and plan cash receipts and disbursements with care. Another important element of the debt burden is the implicit impact of various forms of debt obligations in the credit-worthiness of a company contemplating future capital needs. The balance between debt and equity may become precarious and forestall further borrowing for some time, until the company has worked itself from under the debt obligations. Having closed off the top, as debt-heavy operations are often characterized, can be a costly endeavor, both in terms of the risk of not meeting obligations as they fall due and in having to turn to much costlier sources of credit or equity funds as additional needs arise.

More important than operating debt and its cost (represented by essentially short-term obligations) for a company in the long run is the cost and proportion of debt in its more permanent form - debt as part of the long-term capital structure of the corporation. Here management must make well-planned decisions which involve the cost and amount of debt relative to investments in expanded or diversified activities. Commitments made here are by their very nature bound to have a much more lasting impact than short-term working capital decisions. At times refinancing or even recapitalization may be involved, with significant and far-reaching changes in a company's capital structure.

Debt service burden implicitly costs a company some of its flexibility. The risk of earnings fluctuations impairing the fulfillment of a contract for fixed debt service is real, and must be carefully appraised. Investments must be judged in broad terms; incremental debt cost is not a sufficient criterion. There is a need to relate the cost and other effects of different types of capital sources to operational and investment strategy.

CREDIT INSTRUMENTS

The wide use of credit instruments has resulted in legal rules covering their purchase and sale and the rights of owners. One of the most important legal features that pertains to them is the quality of negotiability. Ordinary transfers of wealth or property rights pass by assignment, since most types of property possess the legal qualities of salability and transferability. The buyer (assignee) is subject to all the defenses that may exist between original parties. Any defect in the title is passed along from the assignor to the assignee. For example, if the assignee purchases a stolen item, the original owner may reclaim it by proving that he is the legal owner. The assignee may sue the assignor, if he can find him, but he has no adequate defense against the legal owner. Most forms of credit instruments have the legal qualities of salability and transferability, but in addition they also may possess the legal quality of negotiability.

The legal title of negotiable instruments is transferred by endorsement and delivery or by delivery only. The transferee obtains a good title, provided that he is a purchaser for value and has no notice or knowledge of any infirmity or defect of the instrument. This is true even though the title of the transfers is defective, which is different from the ordinary contact wherein the assignee is subject to all the defects and defenses that may exist between the original parties. It is intended that negotiable instruments be transferred from hand to hand like money (one aim of the uniform Negotiable Instruments Act is to free owners from defenses that earlier holders may have asserted and, therefore, from claims of other parties).

CORPORATE DEBT – BONDS

A bond is a written or printed acknowledgement of debt or a contract to pay money, and it is usually one of a number of similarly issued instruments. Usually, a bond is a long-term obligation at the time of issuance and assumes a life-expectancy of the borrower to be at least equal to the maturity of the loan. Corporate bonds are classified in many ways, the most common being as debenture bonds, mortgage bonds, collateral trust bonds, and guaranty bonds.

DEBENTURES

Debenture bonds are unsecured promises to pay dignified by a formal indenture, the interposition of a trustee, and marked by the participation of many individual creditors. Debentures are backed only by the general credit of the corporation, and no specific real estate or property stands as security behind them. The indenture, a written agreement which is held by a trustee, describes the rights and remedies of holders of bonds for broken promises given by the debtor.

In general, limitations are placed upon (1) the issuance of new bonds, (2) dividend payments when working capital is depleted, (3) procedure to be followed by trustees when agreements are violated, and (4) the use of funds raised by the bond sale. As in all types of bond issues, many creditors are participating in advances of funds to but one corporate debtor. Debentures are the most common type of bond issued by big, well-established industrial companies, and they have been favored increasingly by public utilities. They may be issued with or without convertible features. If convertible, the holder can, under certain conditions, exchange them for shares of stock. There are many convertibles on the market and their terms vary widely, but all of them offer the owner the privilege of converting his bond into a specified number of shares of common stock.

MORTGAGE BONDS

Mortgage bonds differ from debenture bonds in that they are promises to pay secured by special liens upon tangible property. The mortgage is held and supervised by a trustee, who acts for the holders of the bonds. The original type of mortgage bonds, with rigid provisions for foreclosure in case of failure to pay interest and taxes, to maintain insurance, and to meet installment-principal payments, has been modified by law and court actions. Thus, the indenture agreements now used in this type of financing, as well as for debenture bonds, are of increasing importance. First-mortgage bonds are secured by a mortgage on all of a company's property, not only on its existing property but sometimes even on all property which it might later acquire. These bonds are considered to be among the highest-grade security investments, because they offer the investor an undisputed first claim on company earnings and the greatest possible safety. The first mortgage takes absolute precedence over the claims of all other owners of a company's securities, including the holders of debentures, adjustment bonds, or secondary-mortgage bonds that may be issued after a first mortgage has been made.

COLLATERAL TRUSTS

The collateral trust bond is similar to the mortgage bond, but it is secured by pledges of other securities, which are held by a trustee as a guarantee that the bonds will be redeemed and interest paid on them. As in the case of mortgage bonds, there is a supplementary agreement obliging the debtor to pay if the pledged property is insufficient. Usually the securities on deposit are worth at least 25 percent more than the total value of the bond issue, and they are frequently the securities of subsidiary companies. Collateral trust bonds most often are issued by holding companies and investment trusts that have chiefly stocks and bonds to offer as security for public borrowing. Like the income bond, the collateral trust bond used to be more popular than it is today.

GUARANTY BONDS

From the viewpoint of security, guaranty bonds stand between debenture bonds and those secured by liens on real or personal property. They include bonded debts of one of the other classes of bonds that have been assumed, guaranteed, endorsed, or otherwise protected by the credit of a second corporation, as sometimes happens in case of railroad mergers. Sometimes bonds are the individual and joint obligation of two or more corporations, as illustrated by the bonds of the federal land banks and the federal home loan banks.

Many minor classes of bonds have appeared as corporation finance has become more complex. Bonds may belong to an open-end or to a closed-end issue. If open-end, additional bonds may be issued under certain specified conditions under the indenture agreement, mortgage, and/or collateral trust agreement. If closed-end, no new bonds of the same line as those already outstanding may be issued. Bonds may also be callable or noncallable. If callable, the debtor company may call them under certain stipulated conditions. Like preferreds, most bonds have call provisions which permit a company to redeem them before maturity, if it has the money. Bonds may be registered both as to principal and as to interest or they may be registered as to principal only. If bonds are not registered as to principal, they are payable to bearer (bearer bonds). Recently there has been a departure from the practice of issuing bearer bonds, and more and more companies are issuing bonds that are registered in each owner's name, just like stocks. Income or adjustment bonds are a kind of hybrid security, something like a noncumulative preferred stock, since they provide that the interest is to be paid on the bond only as it is earned (net profits). If earnings are sufficient to pay only a part of the interest on such bonds, the company must make whatever payment it can to the nearest one half of one percent. Such bonds are used widely in adjusting fixed-interest debts of bankrupt corporations, which has given them a bad name. But because of the tax advantage, preference bonds might be used more commonly in place of preferred stock.

Bonds are also classified according to the provisions made for repayment of the principal. If a certain quantity of the total borrowed is repayable annually or at definite periods so that the debt is steadily reduced, the bonds are called serials. Serial bond issues are common among public issues, particularly those of local governments. If all bonds are due on a particular date, they are called term bonds. The term bonds are paid either out of a sinking fund that has been built up over the life of the bond issue for this purpose (with enough paid into it every year to demonstrate that the company would ultimately be able to meet its obligations) or with proceeds of a new security sale. If the bonds are put out for a definite period but are callable after a fixed lesser period, they are known as callable term bonds. Perpetual bonds have no maturity date.

MATURITY

The question of maturity - how long a life the bonds will have, how soon the company will have to redeem them or pay them off - is just as crucial as the interest rate for any company issuing bonds.

In general, the stronger the company, the longer the maturities. There is a wide variation in how long bond issues run, but a period of twenty or thirty years is about as common as any. The railroads have issued bonds with the longest life, and they also have some with about as short a life as any. Many old rail bonds run for 100 years, and some have no maturity date; they were issued in perpetuity - a frank recognition of the fact that no one expects the rails ever to pay all their debt. At the other end of the scale, with maturities of only ten or fifteen years, are the equipment-trust obligations. These bonds are the cheapest method by which railroads can acquire new cars and locomotives; some have carried interest rates under 1-1/2 percent. On this kind of bond, the equipment itself stands as the guarantee of repayment.

The maturity of a bond can effect the yield of a bond, depending upon whether it is sold at a discount or a premium, which in turn depends upon market yield.

INTEREST RATES

Bond interest rates vary not only with the health of the company but also with general business conditions. Over the years, AAA bonds - the highest grade there is - have paid from 2-1/2 percent to 6 percent, but a rate of 4-1/2 to 5 percent might be considered more typical. When money is tight - when banks increase the rates they charge on mortgages and loans, and increase their interest rates on deposits - bond interest rates go up too. The interest rate of a bond is frequently referred to as the coupon rate, because traditionally bonds have appended to them a number of detachable coupons, one for each six months of the bond's life (with one exception, bonds call for interest payments at stated intervals, usually every six months). The owner, or bearer, clips each coupon as it comes due and presents it to the company's paying agent for payment. Traditionally, coupons were used because bonds were not registered in the owner's name, as stock certificates are. Coupons are still used for the payment of interest on some registered bonds, but on others the bond holder gets a check automatically from the company, and this practice has become increasingly popular.

BONDS

Bonds always represent borrowed money which the company that issues them is obligated to pay. Such obligations are a kind of promissory note. When a company sells bonds, it borrows the money from the buyers, and the bonds stand as a formal evidence of that debt. Each bond is an agreement on the part of the company to repay the face value of the bond - usually $1,000 - at a specified time and to pay a set annual rate of interest from the day it is issued to the day it is redeemed. Since bonds represent debt, if a company is dissolved the debt it owes its bondholders, like any other debt it owes for labor and materials, must be paid before the stockholders, common or preferred.

PRIVATE EQUITY FINANCE

A stock certificate is the written or printed evidence of ownership of shares of capital of a corporation. A certificate may be issued for any number of shares to indicate a stockholder's total ownership in a corporation, but, if shares are purchased at different times, several stock certificates may be issued to one individual. All shareholders are proprietors or owners rather than creditors of their corporation. A stockholder receives a share in the earnings, which is called a dividend. In general, dividends are paid only when earned and voted by the board of directors. Most stockholders of large corporations have little to say about the policies of their corporation, and, if they vote at all, it is by proxy. In deciding to buy stock, such investors are guided by investment rather than by managerial motives. This is true particularly of those who buy stocks that are traded actively on organized stock exchanges and in the over-the-counter markets.

PREFERRED STOCK

There are many ways of classifying shares of stock, but the two most general classes are preferred and common. Preferred stockholders have prior claims to earnings and, in the event of liquidation, usually to assets. In return for this preferred position, preferred stockholders usually accept a limited rate of return and surrender voting rights except when their rights and privileges are involved (such as issuance of new preferred stock with equal or superior rights, cancellations of accrued dividends, voluntary dissolution of the company, and so on). If preferred stock dividends are omitted for a stated period, preferred stockholders may be authorized to vote for all or to elect a specified number of directors.

Preferred stock is called a hybrid security because it has characteristics of both stocks and bonds. Preferred stock may be cumulative or noncumulative, participating or nonparticipating. If it is cumulative participating stock, it means that, if actual dividends are less than the preferred dividend rate one year because of low earnings, an amount equal to the difference becomes an obligation due preferred stockholders that must be paid before dividends are paid to common stockholders. If earnings are above the preferred dividend rate, the participating preferred stockholders may share (depending upon the participation clause) in the excess earnings on the same basis as common stockholders, or on some other basis.

Most preferred stock issues assure to the owners a prior claim on all assets of a corporation after all debts have been taken care of, should it ever be necessary to dissolve the company, and carry a specific dividend payable every year on every share before any dividend can be paid to common stockholders. Sometimes such a preferred dividend is not paid in a given year because the company did not earn enough to cover it. But more usually the preferred stock is cumulative preferred (if the company cannot pay the dividend in any year, the amount due for that year accrues to the preferred stockholders and will be paid the following year or whenever the company has sufficient earnings to pay it - if the company could not make the payments on the preferred for a period of years, they would continue to accrue during all that time and would have to be paid in full before the common stockholders could receive any dividend payments). Cumulative preferreds are by all odds the most common, but there are some noncumulative issues on the market - principally those of railroads. Occasionally, on cumulative preferreds, accrued dividends pile up in bad years to a point where it becomes impossible for a company to pay them. In such a situation, it may attempt to negotiate a settlement with the preferred holders on the basis of a partial payment. However, some companies have paid off more than $100 a share in accumulated back dividends due on their preferred stock issued at only $100 a share.

Most preferreds are non participating, but there are many exceptions. If an issue is nonparticipating, it means that the holders of the preferred do not participate, beyond the stipulated dividend payment, in any of the extra profits the company might earn in good years. Even if earnings were so good that dividends on the common stock were doubled or tripled, the holders of the preferred would still get just their set dividend per share and no more. Furthermore, they would have no participation in company affairs and no voting rights except on matters that might adversely affect the rights guaranteed them as preferred stockholders. However, they might be guaranteed the right to elect a set number of directors to the board if the company should ever pass, or fail to pay, the preferred dividend for a specified number of consecutive quarters.

CONVERTIBLES

Another kind of preferred stock that has become increasingly popular in recent years is the convertible preferred. Such a stock carries a provision permitting the owner to convert it into a specified number of shares of common stock, probably within a set time limit. Obviously, there would be no advantage to the preferred stockholder in making such a swap unless the common stock had advanced to a market price that, in sum, equals or exceeds the price of the preferred. The price of a convertible is apt to fluctuate more than the price of other preferreds because a convertible is always tied to the common stock of a company. This has its good and bad points for the investor. If the company is successful and the price of its common stock rises, the holder of a convertible preferred will find that his stock has had a corresponding increase in value, since it can be exchanged for the common. On the other hand, if the common declines, the convertible preferred is apt to suffer too, because one of the features which was counted on to make it attractive has suddenly lost something of its value, and the other features of the issue, such as its dividend rate, may not prove as attractive or substantial as those of orthodox preferreds. Convertibles are always especially popular with investors when stock prices are rising generally.

Most preferreds carry a provision which permits the company to call in the issue and pay it off at full value, plus a premium of perhaps five percent. A company usually will exercise this right to call in its preferred stock if it thinks it can replace the outstanding issue with one that carries a lower dividend rate. However, an issue of second-preferred can be made, with due recognition to the prior claim to assets and earnings granted to the owners of the previous issue of preferred, without calling such a previous issue.

Although nonparticipating convertible, cumulative, callable preferred issues might be regarded as having fairly typical terms, there is no such thing as a standard preferred stock. About the only common denominator of all such issues is the guarantee that the owner will be accorded a preferential treatment, ahead of the common stockholder, in the payment of dividends and in the distribution of any assets that might remain if the company was liquidated. That is why it is called preferred stock, and that is why its price usually does not fluctuate, either up or down, as much as the price of the company's common stock. From that point on, specifications vary widely. Most preferreds have a $100 par value, but some are no-par stocks. Dividends range from four percent up to six percent or seven percent, with the higher dividends prevailing in periods when interest rates on borrowed money are high.

Many preferreds are issued to acquire another company, but most of them are issued simply to acquire more capital for expansion or improvements at a time when the company's circumstances are such that its stockholders and the public at large might not be willing to invest in more of its common stock.

SUBSCRIPTION WARRANTS

A subscription warrant may be a short-term, intermediate, or long-term credit instrument. It is a written or printed document that authorizes the owner to subscribe to new stock under the conditions stated therein (price, method of payment, time period, and so on). Sometimes warrants are attached to bonds to enhance their salability, but more often such warrants are issued to represent the pre-emptive rights of old stockholders to buy new issues of stock or bonds convertible into stock. Stock purchase rights are prorated among existing stockholders according to the number of shares owned; if they are not used within the time specified, the privilege lapses. Arrangements whereby rights may be sold to others usually are made by listing the rights on a stock exchange or by arranging for their sale through investment banking houses.

Sometimes corporations give their officers stock-purchase options at or near the market price of the stock when the options are issued. Customarily, such options are for periods of from ten to twelve years from the date of issue; if the company prospers and the market price of the stock increases, the options may be exercised at the price stated in the option. Usually such stock-purchase options are issued under executive incentive plans.

COMMON STOCK

Common stock is basic to all corporate business. By owning a share of stock in a company, an individual owns part of that company - the shareholders own the company in common. The common stock certificates of a corporation represent the claims of stockholders after creditors and preferred stockholders have received interest and dividends. They may have a definite face or par value, or they may be issued without par value. Owners have a residual claim to earnings and assets. Thus, common stock differs from borrowed capital; it is proprietary, ownership, or equity capital, which means that (1) the business firm using equity capital is not legally bound to pay any income return to those who provide it, (2) there is no stated time when the funds provided by owners must be returned, and (3) those who own it are responsible, at least in theory, for the control and management of the business enterprise.

In addition to the risk assignable to the nature of the business, there may be an added financial risk assumed by common stockholders owing to the financial structure of the corporation. This risk is determined by the relationship between fixed charges and the income available, after taxes, to meet these fixed charges. The leverage of the capital structure - the face value, term, and interest rate of bonds outstanding, fixed charges on bonds, the number of shares, the par value and dividend rate of preferred stock outstanding, dividends on preferred stock; and the number of shares and par value of common stock outstanding - affects changes in earnings assignable to common stock. Operating income, after taxes, must be applied first to interest on debt, then to preferred equity dividends and finally to common equity dividends, but a relatively small percentage increase in operating income above fixed charges can mean large common stock dividends. This method of financing with senior securities (bonds and preferred stock) is called trading on equity (but only in a nontechnical sense, because preferred stock also represents equity in the legal sense). Any increase in earnings is passed through the senior securities and pyramided into a wide fluctuation of earning assignable to common stock. In financial circles this proportionate change in the return on common stock in excess of operating income is called the leverage factor.

If a company has an investment opportunity that provides a return equal to or in excess of the opportunity cost (the most favorable price that can be commanded by a factor of production which thus tends to become the minimum cost at which that factor can be had by any entrepreneur) of funds employed in the project, it should accept the project. If an objective of maximizing the value of the firm to its shareholders is assumed, this opportunity cost should be the rate of return on the project that will leave unchanged the market price of the firm's stock. Thus, if the acceptance of an investment project is expected to result in a higher market price, the project should be accepted, and the firm should raise capital to finance it. As long as investment projects are expected to provide a return greater than that required by investors at the margin, the firm is justified in undertaking the projects and financing them.

A firm should issue common stock as part of its total financing if it is advantageous for it to do so. Although common stock financing will result in a temporary dilution in earnings per share, this dilution should at least be offset by the expected future returns from the project. This does not suggest, however, that new common stock need be issued. To the extent that the number of investment opportunities is limited, it may be possible to finance growth through the retention of earnings and the debt that the increased equity base will support. Earnings retention has several advantages over common stock financing. For one thing, the sale of stock is best suited to raising large blocks of capital at one time, while the retention of earnings is steadier over time and therefore is better suited to financing a steady stream of capital expenditures. In addition, flotation costs and the underpricing of a new issue of stock make it a more expensive method of financing. Finally, the differential tax rate between dividend income and capital gains creates a bias in favor of the retention of earnings. Thus, the retention of earnings has several advantages over the sale of common stock.

However, retention represents dividends foregone by stockholders; therefore, investors' preferences must be considered. If investors have a systematic preference for current dividends over capital gains, this preference may partially or wholly offset the advantage of earnings retention. Overall, there still may be justification for retaining earnings rather than selling common stock. Firms without reasonably abundant investment opportunities simply may have no occasion to sell common stock. Earnings retention, the debt that these retained earnings will support, and funds provided through depreciation may be sufficient to finance all acceptable investment opportunities.

One reason for the reluctance of management to sell common stock is the immediate dilution that results. Upon announcement of the offering (or before, if rumors are out), the market price of the stock usually drops. In the long run, however, this initial dilution in the earnings per share would be expected to be more than offset by the expected gains from the investment projects undertaken. Otherwise, common stock should not be sold. Another reason for reluctance to sell common stock is the inconvenience. A great deal of work is necessary to prepare papers, register the issue with the SEC, negotiate with underwriters, etc. A number of large companies have almost completely avoided common stock financing due to the fear of dilution, the risk of having to maintain cash dividends on the additional shares issued, and the feeling that retained earnings have no cost. Many financial executives take a play-it-safe attitude and are unwilling to subject themselves to possible criticism from outside suppliers of capital. In fact, a number of companies have repurchased their own stock. Repurchase of stock can be justified when there is a lack of acceptable investment opportunities and the firm wishes to distribute excess funds. When stock is repurchased with the full intention of retiring it, the transaction can be treated as an alternative to paying cash dividends. Although they were once greatly reluctant to repurchase their own stock, companies have been doing so increasingly.

The danger in the use of borrowed capital is that the corporation will overborrow during good times and will have too large a fixed debt to be serviced when returns on capital are very low. In the past this has been one of the primary reasons for the failure of railroads and other large corporations. Following financial difficulties during the 1930s, corporations began to finance more with funds from operations (accounted for as retained earnings and depreciation allowances), common stock, and short-term and other bonds with callable features. Currently, the pressure to finance with debts is considerable because in computing the base for payment of Federal corporate income taxes as well as many state income taxes, interest on debts is deductible. When corporate taxes are taking almost half the taxable income, the savings that result from financing with debts rather than with common or preferred stock are great. Although financing to a greater extent with stock (equity) is recognized as socially and economically desirable, the use of this method of strengthening the economic system has been retarded by the corporate tax structure.

INVESTMENT BANKING

While monetary financial institutions such as commercial banks create both money and credit, nonmonetary financial institutions create only credit. Bringing together ultimate leaders and ultimate borrowers is the principal function of nonmonetary financial intermediaries. Credit and credit instruments may be classified as public or private; secured or unsecured; short-, intermediate, or long-term; commercial/mercantile, investment, speculative, consumer, or bank. Instruments of short-term credit include promissory notes, bills of exchange, and the like. Instruments of long-term finance include stock certificates, subscription warrants, bonds, and long-term notes.

Traditionally, bank credit was associated with short-term loans to business firms, however, bank credit now is invested more freely in long-term debts of business firms, homeowners, governments, and others. Yet, generally, bankers prefer to lend rather than to invest and prefer to make local loans rather than those that originate in distant places. The general rule is that a national bank may not purchase or acquire corporate stock except to protect itself against losses on debts owed the bank or as permitted by law in special cases, such as SBIC's.

MONEY MARKET

The money market is the place where the demand for and supply of short-term funds meet. The capital market is the field wherein long-term instruments of finance are bought and sold. The New York money market is the primary money market in this country, but there are others in large cities wherein national, regional, and other needs for funds are met. The primary participants in the money market are broker-dealer specialists, large commercial banks, large investors, investment banks, and the Federal Reserve System.

The capital market is dominated on the supply side by institutional investors. The intermediaries in this market are the investment bankers, who underwrite and distribute securities.

INVESTMENT BANKING

Investment bankers specialize in raising the kind of money that business needs for long-term use, usually in amounts considerably greater than $1,000,000. Investment bankers purchase new issues of securities, pay cash with funds borrowed, in large part, from commercial banks, and repay the loans when the securities being underwritten are sold to investors. If a company's condition is sound, if its prospects are good, and if the stock market is very active and healthy, an investment banker may agree to underwrite an issue of common stock to provide equity capital. For the risk the investment banker assumes in buying all of the new stock and reselling it at a fixed price per share to individual buyers, the risk that he may not be able to resell the entire issue, he expects to make a profit on each share of the issue. On small issues, involving only $1,000,000 or $2,000,000, he may be able and willing to carry the whole risk himself, but on most issues he shares the risk with other investment bankers who join with him in forming an underwriting group under his management. When it comes time to sell the issue to the public, the underwriters usually invite other security dealers to join with them in a selling group, or syndicate.

The costs of underwriting and selling an issue of stock depend primarily on how saleable the underwriting group thinks the issue will be when it is put on the market. Those costs might run anywhere from 3 percent to 10 percent of the final selling price, and they are wholly paid by the seller. The buyers get such stock at the announced price, free of all commission cost or other charges. For penny stock issues, charges might even run as high as 20 percent, since they can usually be sold only by costly merchandising effort. A third to a half of the total commission on any new issue might go to those who underwrite it, with the manager of the group getting an extra fee for his services, and the balance to those who sell it. But, if the issue looks as though it might be sticky, or hard to sell, the selling commission is likely to be increased and the underwriting commission reduced correspondingly.

Whenever a company wants to raise capital by selling a new securities issue, it may well shop around to see which investment banker will offer the best terms and handle the new issue at the lowest total cost. Once a bid is accepted, the relationship between the company and the underwriter is apt to develop naturally into a close one, and if the company needs to raise additional capital at some future time, it may well expect to get help again from the same underwriter, and it may not even ask for other bids. However, by law or government regulation, public utilities are generally required to submit any new securities issue to competitive bidding. Competitive bids are also compulsory on railroad securities, but the Interstate Commerce Commission, which exercises control in this field, usually exempts the railroads from this requirement.

While most companies might prefer to raise new capital by selling stock, this is not the kind of securities issue which an investment banker is most likely to sanction in the case of a comparatively small company. He is more apt to suggest an issue of bonds rather than an issue of stock. Often, in normal years, the aggregate value of new bond issues exceed the value of new stock issues by three or four to one.

Investment bankers take into account a company's immediate and future needs for funds, the mode of financing, and many technical problems. In order to determine the investment quality of a proposed issue, the investment banker must make a thorough analysis of the credit worthiness of the applicant, with consideration given to both short-term and long-term factors. Because the cost of investigation is considerable, the investment banker usually obtains an option to underwrite the issue before making more than the briefest type of investigation. Then, with the aid of accountants, business analysts, economists, and lawyers, he checks the prospective issuer as to the following:

- earnings and earnings prospects,
- condition and efficiency of equipment and plant,
- anticipated use of new funds,
- capital structure,
- corporate powers,
- financial statements.

The investment banker must then estimate the reaction of the market to the proposed issue and determine how the terms can be drawn so as to make the issue command the best price (in case of bonds, the interest rate, maturity, call features, conversion features, timing of offering, price to the investment banker, and price to the public).

Although investment bankers seldom buy securities to hold as investments, they want to make a profit and at the same time establish a reputation for sound merchandising. In order to remain in business, they must have satisfied clients who will buy their new offerings. While an investment house usually finds new customers (issuers) through promoters, finders, and their own officials and agents, some borrowers bring their needs directly to the attention of the investment house. The volume of financing for new customers is relatively small compared with that for old customers.

When credit risks are small and securities offered are of standard quality, requiring little credit investigation, the issue may be sold to the highest bidder.

Many corporations negotiate with their investment bankers when planning to offer new issues of securities. The investment banker chosen is usually one with whom the corporation has had previous experience; and he, in cooperation with other investment houses, will agree to give the issuer a check in return for the bonds or stock certificates that constitute the issue. Negotiation, the oldest method of placing securities on the market, will determine the type of bond or stock issue to be offered, the time of offering, provisions for meeting registration requirements, terms of the offering - such as interest rate, maturity, sinking-fund provisions, redemption prices, security for bonds, and restrictions on the corporation.

The justification for the existence of the investment banker, like that of any specialist, is that he can do certain things better than others can do them. By knowing investment conditions better and by having contacts with prospective investors, the investment banker is able to raise capital funds more successfully.

REGULATION OF SECURITIES ISSUES

Whenever a company wants to raise capital by floating a new issue of stocks or bonds, it must comply with the Federal law that governs the sale of any such issue offered to the public. The Securities and Exchange Commission administers both the truth in Securities Act and the Securities Exchange Act among others. The general objectives of the laws that the SEC administers is to protect investors and the public against malpractices in financial or securities markets. To this end, use has been made of registration and licensing requirements for security dealers and brokers, registration of specific issues, and civil and criminal prosecution for malpractices. The SEC requires full disclosure of all the pertinent facts about any company before it makes a public offering of new stocks or bonds. The company must file a lengthy registration statement with the SEC in which it sets forth the data about its financial condition - its assets and its liabilities, what it owns and what it owes. It must also furnish the profit and loss record for the past several years. It must describe all of its outstanding securities and their terms and must usually list all of its officers and directors, together with their salaries, bonuses, and stock interests in the company, and it must provide a description of its operations. If the data appear to be complete and honest, the SEC gives a green light to the new issue. But this does not mean that it passes any judgement whatsoever on the quality of the securities, how good or bad they may be for the issuer or any investor.

The SEC also sees that the information which is filed with it is made available to any possible buyer of the new issue. A company is required to put all of the essential facts into a printed prospectus, and every security dealer who offers the new stock or bond for sale must give a copy of that prospectus not only to everyone who buys the new issue but to everyone from whom he even solicits an order. These prospectus regulations are binding for 40 days on all companies whose securities are already publicly owned, but Federal law provides that the prospectus period shall be 90 days in the case of companies that are offering their stock to the public for the first time. During the period when a new issue is under prospectus regulation, the securities industry is forbidden to disseminate any public information about the new issue or any other securities of the issuing company, and the advertising of the new issue itself is restricted. The complete prospectus or a fairly detailed summary of it can be published, but barring that, the only other kind of advertising that can be used is the so-called "tombstone" announcement, in which no information is provided beyond the name of the issue, its price, its size, and the names of the underwriters and dealers who have it for sale. Above this announcement the underwriters usually insert a precautionary note to the effect that the advertisement is not be interpreted as an offer to buy or sell the security, since the offer is made only through the prospectus. The prospectus is usually about twenty to thirty pages long. However, some well established companies, notably utilities, that can meet certain high standards of financial responsibility are permitted by the SEC to use a short-form prospectus.

Even if a company satisfied all the requirements of the SEC on a new issue, its troubles may not necessarily end there. Most of the states also have laws governing the registration and sale of new securities. While the requirements of these so-called "blue sky" laws are much like those of the SEC, they are sufficiently varied to cause a company a lot of trouble and a good deal of extra expense in filing the necessary forms. All told, preparing a new issue for sale can be a very expensive undertaking. The bill for preparing the necessary forms and printing a prospectus may run to over $100,000. This is the case when a large company brings out a new stock issue and has to offer rights to all its stockholders, for each of them must be supplied with a prospectus. Fees for lawyers and accountants can add a lot more to this bill. However, the Federal laws, as well as most state laws, provide an out for little companies. For instance, if the new issue has a value of not more than $300,000, the company need file only a short registration form with the SEC. This is known as a Regulation A (small issue) filing, and companies using it can satisfy the requirements of the law by distributing an abbreviated prospectus or offering circular. On issues of less than $50,000 it is not even necessary to prepare a circular. If the new issue can be classified as a private placement - usually one that will be offered to fewer than twenty-five buyers - rather than as a public offering, it does not even have to be registered with the SEC.

In the case of a small company, the investment banker would try to qualify any new issue as a private placement by lining up one or two institutional buyers, perhaps an insurance company or a charitable foundation, before the deal was finally set, and that is why we would insist that the issue be of topflight quality (probably meaning a first-mortgage bond).

While the SEC's full disclosure rules have undoubtedly done much to protect the investor, it is probably also true that they may deter some companies from trying to raise new money for expansion. While these rules have been criticized for being more exacting than they have to be, the prohibition on disseminating any information about a company while its new issue is under prospectus regulation can work unnecessary hardship on investors who have an understandable interest in the company's other securities. The intent of the rule in this latter case - to prohibit promotion of the new issue - is good, but the application can be restrictive.

The laws provide for public disclosure of pertinent facts about new issues and those listed on national securities exchanges, but they do not insure against the issuance of worthless securities. Regulation of trading in securities on exchanges and in the over-the-counter market requires, among other things, that each officer, director, and all others owning ten percent or more of any class of registered equity securities, report monthly on changes in his holdings. In enforcing the laws and the regulations under the laws, the SEC has cooperated with securities markets, different associations, and state enforcing agencies. The SEC maintains regional offices, has its own staff of investigators, keeps files on persons connected with illegal or fraudulent securities practices, and may report violations of the law to the attorney-general of the U.S. for criminal prosecution. Many states now have their own agencies to regulate securities selling, and they have done much to supplement the work of the SEC.

SUPPLY OF NEW EQUITY FINANCING BY INSTITUTIONAL INVESTORS

The rising institutionalization of equity markets has aroused concern, on occasion, that a preference on the part of institutional investors for securities of larger companies obtainable in larger and more liquid positions, would severely restrict the ability of smaller companies to obtain equity capital. However, in periods of increasingly restricted credit and unusual market activity when all investors, including institutions, tend to make riskier investments, the participation of financial institutions in the financing of corporations has been found to be significant in the area of venture capital investments.

This is particularly important, since by definition these transactions represent investments in smaller and, perhaps more important, newer companies without the history of operations or equity base to attract other forms of capital. A 1971 study by the Securities and Exchange Commission has revealed that in cases of institutional purchases of first offerings and restricted securities, the issuers were much smaller than the companies usually held in institutional portfolios. The willingness of institutions to depart from their usual investment practices to purchase the securities of small companies may be attributed to the potential rates of return available from these investments, relative to the risks the purchasing institutions must bear. And, although institutional participation in direct equity financing of corporations is important to those corporations, it is not in the aggregate significant to institutions. For example, only 0.3 to 0.4 percent of gross purchases of securities by institutions are purchases of securities in first public offerings.

Approximately twenty-five percent of the value of venture capital transactions, where venture capital investment is defined as the purchase of a security in a private placement from an issuing company whose average net earnings over the two years preceding the year of purchase did not exceed $250,000, reported by broker-dealers in 1971, involved companies with a deficit; and an additional 58 percent involved companies with earnings of less than $100,000. The comparable figures for venture capital investments made by financial institutions were 29 percent and 51 percent, respectively. This tendency to invest in newer companies is limited, however, by the tendency [illegible] institutions to concentrate their venture capital investments in relatively few industries, including those industries which have attracted considerable attention during periods of heavy market activity. In addition, the placement of venture capital investments has been concentrated among relatively few broker-dealers.

Obtaining venture capital often lays a foundation for ultimately obtaining public financing, generally within a relatively short time after the investment. Presumably, the equity base provided by venture capital investments also facilitates the obtaining of other forms of capital, such as bank loans, by such companies. However, this appears to be an expensive source of financing for these corporations.

Potential gains to financial institutions and others making venture capital investments are significant. Investmens made at substantial discounts result in significant potential profits to the institutions involved.

Financial institutions also have contributed significantly to the equity financing of corporations through purchase of restricted securities (securities which, generally, cannot be resold immediately by the purchaser without registration under the Securities Act of 1933). Here, as with respect to venture capital investments, potential gains accruing to purchasers of restricted securities, including financial institutions, are significant. The average discount from market price of securities of the same class applied to purchases of restricted common stock generally has been higher for over-the-counter stocks than for the listed stocks. (Restricted securities are usually sold at a discount from their coeval market price, if any, primarily because of the restrictions on their resale). Investment advisors have obtained higher discounts than banks, perhaps because investment advisers tended to purchase proportionately more of the securities of smaller, less established companies. The discounts on average have been higher in periods of higher stock prices.

Purchases of restricted securities have been concentrated among a relatively small number of institutions. Institutional holdings of restricted securities involve smaller, less established companies than the companies whose marketable securities are held in institutional portfolios.

Financial institutions have further participated in equity financing of corporations, particularly smaller corporations, through purchases of securities in first public offerings. Issuance of securities by smaller corporations (as determined by sales and net earnings) has in recent years been an important factor in absolute terms in number of offerings and in aggregate dollars raised. It has also been important in relative terms, compared to new offerings by larger more established companies; and compared to the volume of trading in the secondary markets. Institutions have played a substantial role in financing these corporations, and the potential gains accruing to institutions from this role have been large.

Financial institutions have purchased, as with respect to their venture capital investments and purchases of restricted securities, securities in first offerings of many less established companies without significant histories of earnings. Differences among institutions in regard to the extent of their purchases of first offerings has been directly related to the sizes of the respective institutions. Large institutions tend to purchase more securities in first offerings. However, the preferences of individual institutions for particular types of investments also have been a factor. And individual institutions appear to have received very limited quantities of first offerings in comparison to the aggregate amount of stock offered in any particular offering.

There has been a concentration of sales of first offerings to institutions among a relatively small group of underwriters. In most cases, these underwriters are also prominent in the retail institutional brokerage business. The concentration among institutions in regard to the purchases of first offerings, although substantial, has been less than in the concentration of institutional holdings of common stock.

Financial institutions do not appear to have received in the aggregate a favored selection of first offerings, based on price changes between the offering and the first market quotation as a measure of popularity. And, the brokerage paid by a particular institution to a particular broker-dealer does not seem to be significantly related to the value of the offerings the institution purchases from the broker-dealer.

The aggregate institutional participation in the market for first offerings has been significant. However, institutional participation in the market for public offerings is less than proportional with the participation in secondary markets. Institutional participation in the aftermarket also has appeared substantial. Institutional purchases of first offerings, as those of restricted securities, including venture capital investments, have been a significant source of financing for smaller companies.

The potential return-relative-to-risk available in the primary market is determined by the conditions of supply and demand for these securities. Given investors' perceived risk, the supply of securities adjusts to a level that is consistent with a perceived potential return. Not all investors, however, need perceive the same level of risk. Those who, for a given potential return, perceive less risk are motivated to participate in the primary market since the market-determined return-relative-to-risk exceeds the amount of return they desire. Institutions' perception of risk may differ from that of many individual investors for several reasons, including: (1) diversification of risk; (2) internal analysis, (3) access to investment bankers, and (4) offsetting less risky portfolios.

A significant component of the risk of investment in small companies is unrelated to the variation of the general market. This component of risk reflects the unpredictable forces operating on the various small companies whose stock is carried in an investment portfolio. Perhaps the most important defense against this risk lies in diversification. The larger the portfolio of risky securities, the greater the opportunity to average out favorable and unfavorable events. The concentration among institutions in their purchases of restricted securities results partly from the advantages of portfolio diversification. Some institutions are reluctant to purchase any restricted securities unless they purchase a large enough quantity to permit diversification of risks.

Institutions who supply funds to small companies have or can obtain the expertise to evaluate the prospects and risks of a given proposal. Since the maintenance of an expert staff requires the willingness and ability to undertake a number of investments, this factor is another force leading to concentration among relatively few institutions.

Institutions may enjoy exposure to a favored selection of venture capital proposals by dint of their access to the more prominent investment bankers. Since most of the investment bankers involved as agents in placements of equity of small companies are also engaged, and usually to a much greater extent, in the distribution of public offerings and the transaction of ordinary brokerage business, institutions, who are also involved in these activities, have occasion to establish relationships with the prominent investment banking firms. To avoid antagonizing their institutional customers, these firms may offer their institutional customers a favorable selection of investment proposals and, equally important, maintain contacts with the issuers after the investment is made.

Most institutions that invest in small companies allocate only a small part of their portfolio to this spectrum of risk, the remainder being devoted to marketable securities of large corporations and to government securities. They are, therefore, in a better position to absorb the potential losses from more risky investments, and, more importantly, to avoid premature withdrawal when the issuers encounter difficulties. Their ability to hold on to an investment obviates their selection of more speculative issues that permit more rapid turnover but at the expense of total reliance on the vagaries of the public market for speculative offerings. Moreover, their access to additional funds permits some institutions to respond favorably to "second calls" on money to protect their initial investment. Individual investors are seldom able to allocate a small part of their total protfolio to investment in small companies and at the same time enjoy the advantages of diversification in these investments.

Institutions are a significant factor in the primary markets for the equity financing of corporations, particularly smaller, less established companies. Institutions purchase securities of smaller companies in the primary markets to a proportionately greater extent than they do securities of issuers of this size in the secondary markets.

The potential rates of return to institutions for their participation in the primary markets for equity financing are large, although this phenomenon is not peculiar to institutional investors. Participation in the primary markets has been concentrated among a relatively small number of broker-dealers and institutions and among issuers in relatively few industries. However, institutions, in the aggregate, have not appeared to have exerted any significant influence on the allocation of resources in the primary markets for equity capital.

OTHER POTENTIAL NATIONAL SOURCES OF CAPITAL

There are a variety of other sources of capital that are potentially available, directly or indirectly, for development opportunities. These sources vary in structure and purpose, and each has legal constraints and investment policies. Some provide long-term capital; others short-term. Some can and some cannot buy equity shares.

LIFE INSURANCE COMPANIES

Assets of all legal reserve life insurance companies in the United States are estimated to be over $177 billion as of December 31, 1967. There are different policies from company to company in regard to the way life insurance assets are invested. In the aggregate, however, the pattern of investments in 1967, is that over 40 percent of investments comprised bonds, with particular emphasis on industrial issues. About 80 percent of these industrial bonds were acquired through direct negotiations with the borrowers, rather than through the purchase of public offerings. Of total assets, 38 percent were invested in mortgages, categorized as farm, non-farm FHA, non-farm VA, and non-farm conventional mortgages. More than 40 percent of the mortgage holdings of insurance companies was in apartment developments and commercial properties in 1967.

Funds held by life insurance companies are mainly available for long-term lending and for some "quasi-equity" investments and are not available for short-term lending.

Smaller business financing is almost entirely long-term and is usually done through the real estate mortgage department, so that the amount of funds a small firm may obtain is dependent upon the value of the real estate it owns. A small company also may be financed by a loan secured by the borrowing company's physical assets, or by an advance made upon insurance on the life of one or more of the proprietors, or, in some instances, private placement of a note or bond of the borrower for a certain term of years. An insurance company is not willing to take unnecessary risks, and venture capital is not considered to be a goal of insurance companies. However, because of the tremendous amount of assets they have, insurance companies have become interested in providing smaller firms with risk capital. One indication of this is that insurance companies represent some of the main investors in small business investment companies. Although the tax advantages of this type of investment are obvious, many insurance firms are genuinely interested in helping smaller businesses.

Some insurance companies have separate departments to make "equity loans" to smaller businesses. They make such loans to render a basic economic service and to provide future investment outlets as the companies grow and prosper. Insurance firms are stimulated also by the likelihood of increased taxation of income from the securities they hold, and they are increasingly seeking capital gains as well as income from common stock.

Many large life insurance companies are heavily involved in a collective commitment of insurance companies to invest $1 billion to rehabilitate urban ghettos. While acknowledging the position that urban poverty and rural poverty are linked by migration, they are not optimistic that a rural program similar to the urban program will be given a comparable commitment. On a practical basis, insurance companies have a large stake in the health of cities, where they have large investments in apartments and office buildings. Furthermore, a major impact is more readily attainable where population is concentrated, rather than dispersed as in rural areas. Finally, the costs of handling mortgages in rural areas are relatively high because demand is diffuse and there is a lack of efficiency without a good system of mortgage brokers or packagers.

TRUSTS

Most of the trust business in the United States is conducted by corporate fiduciaries, which usually are commercial banks with trust departments. Trust departments provide a wide variety of services, such as the settlement of estates, administration of guardianships, the performance of agencies for individuals and corporations, trustee for endowments as well as trustee for employment pension and profit-sharing plans.

In administering a trust, the trustee's powers are limited by applicable state trust investment statutes, court decisions and the wishes of the trustor as expressed in the trust instrument to be considered. The general effect of investment powers and limitations is to impose on a fiduciary a high degree of responsibility for investment decisions. In general, fiduciaries are permitted to invest in corporate bonds and stocks, U.S. Government securities, real estate and real estate mortgages, and the securities of state and local governments.

U.S. Government securities and other bonds comprise about 27 percent of trust assets; common stocks about 62 percent. Smaller trust departments invest a correspondingly smaller percentage of assets in common stocks and a larger percentage in U.S. Government securities. Trust departments with under $10 million in trust assets typically invest only 45 percent in common stock and over 15 percent in U.S. Government securities. Because of the special nature of trust, trust funds can only be applied to industrial development projects if suitably safe securities are available. Thus, trusts aren't a direct source of capital for new industry, but provide a potential source of capital for a development fund which relies heavily on bank investments.

COLLEGE ENDOWMENT FUNDS

A college endowment is a fund, the principal of which is invested and not touched and only the income is used for the support of the college or for some specific object in connection with it. Contributors include alumni and non-alumni, business corporations, religious denominations, general welfare foundations, and associations and labor unions.

Endowment fund managers, historically, have been reluctant to substantially increase their investment in stock holdings above 55 percent of total investments. Security and yield are prime investment criteria, similar to trust funds.

PUBLIC RETIREMENT FUNDS

A public retirement fund aids workers by providing against insecurity in old age and disability and assists them in making provisions for their immediate dependents. Almost all full-time employees of state and local governments are in some form of retirement fund. Retirement funds include coverage of teachers, policemen and firemen, clerks, mechanics, and other employees of state and local governments. Assets of all state and local public retirement funds approached $40 billion in 1967, about two-thirds of which were assets of state retirement funds. Sources of these funds were a combination of employee and government or employer contributions and earnings on investments.

The investment objectives of public pension funds are the realization of the maximum amount of earnings consistent with safety of principal. Administration of public retirement funds is restricted by legislative controls and statutory regulations and rigid screening by public agencies. Investment operation of public retirement funds is highly conservative.

Approximately one-fourth of all state retirement funds typically are invested in U.S. Government securities; corporate bonds constitute an additional 45 percent. Municipal bonds are a relatively small percentage since public retirement funds as public agencies are exempt from direct federal taxation and do not gain from investment in tax exempt bonds.

FOUNDATIONS

There are now over 30,000 private foundations in the United States, compared to about 7,000 in 1949. They have a total net worth of over $20 billion and hold 2.1 percent of all common and preferred stock in the nation.

Large foundations, historically, invest about one-half of their portfolios in U.S. Government securities and about 20-25 percent in corporate bonds. Since foundations have a tax-exempt status, they do not benefit by investing in tax-exempt municipal bonds.

WHERE TO OBTAIN INFORMATION ABOUT FOUNDATIONS

The Foundation Center

888 Seventh Avenue
New York, N. Y. 10019
(Main Office)

1001 Connecticut Avenue, N.W.
Washington, D.C. 20036
(Branch Office)

The essential facts on almost all foundations are readily available at the above offices which are open to the public. The Foundation Center, an independent, nonprofit organization, maintains comprehensive files including the reports published by foundations; a continuing record of foundation grants, indexed by fields; and general literature on foundations and philanthropy.

The Center compiles the principal reference work on foundations, THE FOUNDATION DIRECTORY, the latest edition (No. 4) of which gives information on 5,454 foundations that either made grants of $25,000 or more or had assets of $500,000 or more in 1969 (this book is available in many university, college, and public libraries), and THE FOUNDATION GRANTS INDEX, a biennial record of grants made by American Foundations, beginning in 1970-1971. The Center also publishes other bulletins and booklets of interest to applicants for funds, public officials, foundation trustees and administrators, students, and the general public.

The Center cooperates in the maintenance of regional collections of foundation materials. These collections, open to the public, are located at the following addresses:

Foundation Library Collection
Atlanta Public Library
126 Carnegie Way, N.W.
Atlanta, Georgia 30303

Regional Foundation Library
The Hogg Foundation for Mental Health
The University of Texas
Austin, Texas 78712

Graduate Social Science Library
Stephens Hall
University of California
Berkeley, California 94720

Associated Foundation of Greater Boston
1 Boston Place, Suite 948
Boston, Massachusetts 02108

The Newberry Library
60 West Walton Street
Chicago, Illinois 60610

Cleveland Foundation Library
700 National City Bank Building
Cleveland, Ohio 44114

Foundation Collection
Reference Department
University Research Library
University of California
Los Angeles, California 90024

The Danforth Foundation Library
222 South Central Avenue
St. Louis, Missiouri 63105

SPECIALIZED NATIONAL FINANCIAL INSTITUTIONS*

THE FEDERAL HOME LOAN BANK SYSTEM

S&L mortgage lending is regulated by the Federal Home Loan Bank System, which was established by Congress in the 1930's to provide a permanent framework for the nation's home financing institutions. The fundamental purpose of the System is to provide a central credit facility to supplement the resources of its member institutions.

In performing this basic function, the System serves as a source of secondary liquidity to its members in meeting heavy or unusual withdrawal demands. It supplies funds to smooth out the differences between the contra-seasonal flow of savings and the closing of construction and home purchase loans. It also supplements local lending resources in capital deficit areas by helping to shift funds from capital-surplus areas.

Most important, the System links mortgage lending institutions to the capital markets by issuing consolidated obligations in large denominations, which are sold to investors and financial institutions. The FHLB System is organized in a manner similar to the Federal Reserve System. It is comprised of the Federal Home Loan Bank Board (FHLBB), regional banks and member institutions.

The regional banks carry out the functions of the System in its dealings with member institutions. Although the regional banks are instrumentalities of the federal government, they are wholly owned by their member institutions. Each bank has its own staff and board of directors. Each board has four public interest directors who are appointed by the FHLB Board for four-year terms. The other directors are elected by the member institutions for two-year terms.

FUNCTION OF THE BANKS

The regional Federal Home Loan Banks serve as central credit banks for member institutions and have no direct contact with the public except through the sale of consolidated obligations. Member institutions transact their business through the bank of their own district.

The major sources of funds for the banks are their capital stock and retained earnings, the proceeds from the sale of consolidated obligations and deposits of member institutions. Advances to members represent the major function of the Banks as reservoirs of credit. However, the cash government investments of the banks are important to them in carrying out their credit function. These liquid assets measure their ability to fulfill new demands for advances, repay members' deposits and meet emergencies.

The System's consolidated obligations are used to tap the capital markets for funds to lend to member institutions. They are issued over the signature of the chairman of the bank board and are marketed through the board's fiscal agent.

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*U. S. Savings and Loan League, *Savings and Loan Fact Book 70*.

FHLBB consolidated obligations are purchased by a broad segment of financial institutions, corporations and other investors such as fiduciary trusts and public funds which are subject to federal supervision and in most states, for savings banks, insurance companies, trustees and other fiduciaries subject to state supervision.

The FHLB System was created for the purpose of extending credit in the form of advances to its mortgage lending member institutions. Advances are subject to a wide range of terms and conditions which are controlled by statute, the policies of the Federal Home Loan Bank Board and the lending policies of the regional banks.

The maximum borrowing limit of any member of the FHLB System is set by statute at an amount equal to 50 percent of its total savings balances. Within this limit the regional banks establish a line of credit for each member institution.

By law, definition and tradition, the Federal Home Loan Bank System is a credit system. At times, however, member institutions are net contributors of funds to the regional banks. More significantly, the system as a whole often gives support and makes financial contributions to, rather than demands upon, the capital markets of the nation.

FEDERAL NATIONAL MORTGAGE ASSOCIATION*

The Federal National Mortgage Association, known in financial circles as Fanny May, was originally chartered in 1938 and was later rechartered with revised powers under the Housing Act of 1954.

The act assigned three functions to FNMA: (1) the maintenance of a secondary market for FHA and VA loans, to provide a degree of liquidity for the home mortgage market; (2) the administration of special assistance programs authorized by the President or Congress to finance selected types of mortgages which could not be financed adequately through the usual lending channels; and (3) the management and liquidation of the FNMA portfolio of loans acquired under contracts entered into prior to 1954.

The Housing Act of 1968 spun off Fanny May from the Department of Housing and Urban Development, establishing it as a government-sponsored private corporation. The new organization was assigned the function of maintaining a secondary market for FHA and VA loans. The special assistance and management and liquidation functions were assigned to a new corporation, the Government National Mortgage Association.

FNMA's dual nature is reflected in its board of directors. One-third of the board's 15 members are appointed by the President, with the remainder elected by the holders of common stock. The law requires that at least one director represent the homebuilding industry, one the real estate business and one mortgage lending institutions.

Under the present statutes, Fanny May must become a quasi-private organization between May 1, 1970, and May 1, 1973. Before it can become a private organization, one-third of its outstanding stock must be owned by corporations or individuals in mortgage lending, real estate and home building. The organization was approaching this requirement at year-end 1969.

The public aspect of the corporation is illustrated by a provision of the 1968 law providing for a direct relationship between Fanny May and the executive branch of the federal government. The Secretary of HUD must approve the organization's borrowing capital, debt ratio and dividend policy, and the Secretary of the Treasury must approve any securities, debentures or notes issued by Fanny May.

The basic operations of FNMA consist of buying, servicing and selling mortgages insured by the FHA or guaranteed by the VA. When mortgage investment funds are in short supply, Fanny May buys mortgages. When investment funds are in ample supply, Fanny May sells mortgages. These purchases and sales provide liquidity in the mortgage market. During 1969 Fanny May purchased $4.1 billion in mortgages (Table 110).

FNMA's effectiveness in the secondary market was greatly enhanced in May of 1968 with the introduction of the Free Market System. Previously, Fanny May announced the price it was

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*U. S. Savings and Loan League, *Savings and Loan Fact Book 70.*

prepared to pay for any government-backed mortgages. The agency's volume was determined by the amount mortgage holders were willing to sell at the pre-determined price.

Under the Free Market System, Fanny May establishes the volume it is willing to buy and accepts bids from FNMA sellers. Fanny May then commits itself to purchase eligible mortgages, provided the offers are submitted in accordance with the rules and regulations that govern Free Market operations. Commitments can be for periods of 90 days, six months or, in the Proposed Construction segment, for as long as 18 months. Approximately 90 percent of the purchases of mortgages by Fanny May are made from mortgage bankers.

FNMA obtains its funds to buy mortgages by the sale of mortgage-backed debentures, short-term discount notes, service fees, common stock sales and Treasury borrowings.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION*

The Government National Morgage Association, often referred to as Ginny May, is a wholly owned corporate instrumentality of the United States government operating within the Department of Housing and Urban Development. The powers and duties of GNMA are vested in the Secretary of HUD. Within the limitations of law, the secretary determines the general policies which govern the operations of GNMA.

Unlike FNMA, which is governed by a board of directors which selects the president and vice president, officers of GNMA are appointed by the Secretary of HUD. They have the responsibility of discharging all executive functions, powers and duties as prescribed in the by-laws of the 1968 Housing Act.

In addition to assuming the management and liquidation functions of Fanny May, Ginny May has an important new responsibility–issuing guarantees of securities backed by mortgage loans. The mortgage-backed security is fully guaranteed by the United States government and bears the full faith and credit of the federal government.

Under the new plan, Ginny May is authorized by law to guarantee the timely payment of principal and interest on securities which are based on or backed by a pool of FHA or VA mortgages. This means basically that mortgages are pooled, a covering security is issued and the repayments from the underlying pool of mortgages are used to pay off the security. Investors purchase shares of varying sizes in the pool.

As of early 1970, there were three basic securities which could be issued under the GNMA Mortgage-Backed Security Program:

The straight pass-through security pays monthly to the investor principal and interest payments actually collected on the pooled loans, in an amount proportionate to the investor's share in the pool. Prepayments received by the issuer must be passed on to investors.

The modified pass-through security pays monthly to investors principal installments due on the underlying mortgages and a fixed rate of interest on unpaid mortgage principal balances. Any principal prepayments received by the issuer must be passed on to investors.

The bond-type security pays seminannually a specified rate of interest, and returns the principal to the investor at the end of the term.

Before the creation of GNMA and its guarantee program, mortgage lending institutions found it difficult to seek out investors in single-family mortgages. Setting up a separate department to handle the paperwork and operations in the issuance of securities was costly. In addition, the illiquidity of home loans made mortgages unattractive to many investors and put mortgages at a competitive disadvantage with alternative outlets for funds.

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*U. S. Savings and Loan League, *Savings and Loan Fact Book 70*.

It is anticipated that the introduction of the GNMA mortgage-backed security will increase the attractiveness of mortgages as an investment by eliminating the cumbersome paperwork and time-consuming red tape connected with mortgage investment. More importantly, the incentive created by Ginny May in the mortgage investment market encourages lending institutions to make more FHA and VA mortgage loans, thus helping to alleviate the shortage of low and middle income housing.

At year-end 1969 Ginny May held $4.8 billion in mortgages (Table 111). Of these, $4.2 billion were FHA-insured and $600 million VA-guaranteed.

PART II

LOCAL SOURCES OF PRIVATE CAPITAL FOR DEVELOPMENT

LOCAL AND AREAWIDE MONEY MARKETS INTRODUCTORY OVERVIEW

The availability and use of local sources of venture and investment capital is a key element in the total process of economic development in rural and nonmetropolitan areas. Some experts believe that the primary emphasis of development progams should be placed on expanding the ability of local sources of private investment capital in rural areas through the provision of credit. These same experts believe that the failure of the private financial system in rural areas to provide sufficient capital funds is one of the major constraints to economic development.

Local financial systems are influenced by the operating characteristics of national financial markets. Although private capital flows freely across the nation through these national markets, nonmetropolitan areas must depend primarily on funds generated locally to support their own development. Once savings are exported outside rural areas to national money markets, studies have shown that little of this capital finds its way back into rural areas.

COMMERCIAL BANKS AND AREA DEVELOPMENT

Private sources of credit at the local level include commercial banks, savings and loan associations, life insurance companies and private individuals. Of these, the commercial banking system provides by far the largest source of credit.

Underdeveloped nonmetro areas are extremely dependent on small and medium sized businesses for job creation. These small businesses are, in turn, dependent on local banks for credit. Since the availability, mobilization and transfer of local funds for investment is often the key to growth and development of nonmetro areas, these areas must depend upon a highly developed and efficient banking system.

OPERATING CHARACTERISTICS OF LOCAL BANKS IN NONMETRO AREAS

Several studies have shown that our rural banking system is not meeting development needs because in too many areas the small unit bank fails to connect its local community to the capital funds system at the state and national levels.

The private rural financial system is dominated almost completely by the small unit bank. Research on small unit banks has found that they are characterized by:

- lending based on personal relationships;
- little use of FHA or VA guarantees, but emphasis on short-term, high-down-payment conventional mortgages;
- relatively low interest rates paid on deposits and charged to borrowers;
- limited participation with other banks in making loans within or outside of the area;
- conservative lending policies characterized by high collateral requirements;
- a low legal lending limit because of the small average size of the banks;
- low lending activity (a 52.5 percent loan-to-deposit ratio compared to the national average of 59.8 percent according to the Checchi study of capital in Central Appalachi;*
- relatively high growth in deposits and capital accounts compared with national averages.

These factors all contribute to a phenomena that several studies have shown prevail in nonmetropolitan areas–the export of potential investment capital out of depressed areas to national capital markets for investment in major metropolitan areas. One reason for the large outflow of capital from these areas is that lenders can earn higher returns from government securities and other investments outside the area. In addition, in many rural areas bankers are often overly pessimistic about local economic prospects and unwilling to accept the higher risks associated with investment in small local enterprise.

Noneconomic reasons also contribute to this capital outflow. For example, small unit banks in rural areas are notorious for basing local investment decisions on personal relationships, often to the

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*Appalachian Regional Commission, *Capital Resources in Central Appalachi*, prepared by Checchi and Company, Washington, D. C., 1969.

detriment of new commercial ventures and outsiders wishing to invest in the area.

However, research has shown that in most rural areas there is enough local capital available to help finance new enterprise. Unlike housing and agriculture, which have a number of credit suppliers, business and commerce is particularly dependent on commercial banks for credit. In fact, in many rural areas local banks are the only private source of business credit. A Kentucky study showed that commercial banks actually furnished more than 98 percent of business credit, excluding highly specialized REA loans.* The amount of bank credit available in rural areas can often make the difference between growth and stagnation. The major bottleneck involves the inability of small businessmen and development leaders to show local bankers that investment in their own areas can be just as profitable as investment outside.

WORKING WITH LOCAL BANKERS

Any attempt to stimulate an increased role for small town banks in the area development process must take into account the constraints inherent in the characteristics of the banking business. It must be remembered that a commercial bank is a business out to make a profit. Yet unlike most other businesses, a bank has a deeper obligation to maintain performance standards and soundness to insure that it will gain acceptance as a reliable institution for the safekeeping of other people's money. Thus, two characteristics of banking operations tend to negate its potential development role - government regulation and self-regulation that must be exercised to maintain depositor confidence.

While legal regulation of banks inhibits their potential development role, these requirements are relatively fixed and beyond the practical scope of day to day dealings with local bankers. However, there is no legal distinction between rural and urban banks. Banks in rural areas can make the same kinds of loans as their big city counterparts. For instance, rural banks can make venture capital loans for new businesses if the enterprise appears to be feasible.

However, the conservative lending policies of small unit banks in rural areas usually stem from self-regulation. Practically speaking, banks in rural areas usually do not make the type of loans necessary to stimulate development. Often they do not take the time to study a loan, usually because they do not have the sophistication, experience and talent necessary to fully evaluate risks.

In some areas, assistance in these technical aspects of bank operations is available to some small banks through correspondent banks in larger cities. Correspondent banks have the capability to provide small town banks with a variety of specialized services including loan packaging, credit references, and industrial development promotion.

A ROLE FOR DEVELOPMENT AGENCIES

The services available from correspondent banks can be supplemented by local and multicounty development staffs who can play a major role in overcoming the conservative lending policies resulting from bankers' self-regulation. Armed with a knowledge of banks' operating policies and a

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*Spindletop Research, Inc., *Credit Trends in Kentucky*, prepared for the Kentucky Department of Banking and Securities, Frankfort, Kentucky, 1971.

working relationship with the local banker, development agencies can place themselves in a position to function more effectively in attempts to tap local savings for development purposes.

As a first step, it is incumbent on development directors to establish a personal relationship with area bankers. This will usually mean getting local bankers involved as active participants in the development organization. Most bankers should be receptive to active participation in community and area development efforts–for as the community and area grows and develops, local banks should realize a corresponding prosperity.

The second key factor involves the need for development leaders to become familiar with their local banks' operating policies and procedures. For example, in most cases, the conservative policies of small town banks mean that any development oriented loan, either to individuals or businesses, will require significant collateral. Familiarity with bankers' collateral requirements and the kinds of collateral banks will accept (equity, real estate, capital assets, potential earnings, etc.) is essential to understanding the requirements of private financing.

Development personnel must also be informed of the criteria which local banks employ in evaluating loan applications including legal limitations, adequate financial statements, credit references, collateral requirements for different types of loans, (i.e., operating capital, investment capital, consumer, commercial, construction, industrial, loans), the various types of loans the bank will consider (secured, unsecured, revolving, accounts receivable, etc.), the services available from big city correspondents, the banker's willingness to become involved in participating loans with other banks outside the area, and his attitude toward participation in Federal loan programs.

For example, bankers often defend their conservative lending practices by pointing to a lack of loan demand in many rural areas. While some studies have found that often little loan demand exists in rural areas, the local businessman is frequently reluctant to even approach his local banker about an unsecured loan.

In many instances an inadequate equity base is the chief reason cited for rejection of loan applications. However, most banks are not experienced in evaluating loan applications on the the basis of inventories, projected cash flow, potential markets and other indicators of soundness that would justify lower collateral requirements.

To increase loan demand, small businesses in rural areas need access to improved technical management support and financial expertise. The problem is further exacerbated by the failure of local bankers to provide local businessmen with expert advice on where to seek additional financing. In short, small business risks could be greatly reduced and more realistically assessed if more technical and financial expertise were available to both borrower and lender in rural areas.

This lack of technical capability at the local level prevents consumers of credit to know when to seek it, where and how to obtain loans, how to make the best use of borrowed money and how to perform the proper accounting and reporting procedures. Development staffs can provide technical assistance to their small community banks and other financial institutions in evaluating investments in terms of the development impact of the loan and in terms of the bank's prospects for receiving a fair return. Even where the local bank demands solid collateral valued in excess of the loan for most new business ventures, the development organizations can work with the loan applicant and the banker to analyze indicators of soundness that may justify lower collateral requirements.

In the latter instance, a major barrier to economic development in many rural areas is the fact that local bankers have not had experience in financing a dramatic expansion of investment. As a result, local bankers often do not have the knowledge and experience to assess the risk of many businesses. This lack of knowledge contributes to the conservative lending policies practiced by many small bankers in rural areas. These practices are characterized by short-term lending with little risk involved, with emphasis on collateralized rather than unsecured loans.

There are notable exceptions to these general patterns of banking activities in rural areas, however. In many growing nonmetro areas, surveys have shown that local banks do respond to local demands for money, particularly where concerted efforts are made to improve the economic well-being of the area. In fact, bankers often provide the key leadership in such efforts. The success of these areas in combining federal, state and local interests and public and private capital to achieve common development objectives is testimony to what effective development leadership at the local level can accomplish.

Many students of the development process believe that an expanding local economy does not depend so much on economic incentives such as low interest rates or federal assistance programs as it does on getting bankers and other financial interests to work with development groups and among themselves to stimulate a concern for areawide economic growth. This local leadership is the key to mobilizing capital and making known to potential borrowers alternative sources of funds. In many nonmetropolitan areas, this vacuum in financial leadership can be filled by development organization staffs and board members.

In summary, a role for the development staffs can evolve as one of intermediary between potential borrowers, usually existing small businesses or new businesses, and local banks in stimulating loan applications, working with both parties in evaluating the applications, and in packaging various sources of credit.

SAVINGS INSTITUTIONS

Savings and loan associations (S&Ls) serve as specialized financial intermediaries linking savers and borrowers. S&Ls are the third largest type of financial institution in the nation behind commercial banks and life insurance companies. They are private institutions established and operated under state and federal laws. As financial intermediaries, S&Ls make loans, accept the risks on the loan, collect the interest from the borrower and pay a portion of it to the saver as earnings on the savings in his account. Operating policy is the responsibility of a Board of Directors made up of local business and professional people. In 1969, S&Ls accounted for 34 percent of all the over-the-counter savings in the nation.

S&Ls, like banks, operate under a dual system of regulations. State associations are chartered and supervised by each state; federal associations are supervised by the Federal Home Loan Bank Board (FHLBB). The maximum interest rate S&Ls may pay on savings accounts is controlled by regulation of the FHLBB.

MORTGAGE LENDING

S&Ls are primarily mortgage lending institutions. Their investments are limited by law, regulation and custom mainly to loans secured by residential real estate, particularly by the single family owner-occupied home. Around 85 percent of their credit goes into mortgage loans for one to four family housing, including both construction and home purchase loans. The remaining 15 percent goes to loans for apartment houses, land development, income producing non-residential property and building lots.

S&Ls are predominately direct lenders, closing loans for their own portfolios without employing or serving as brokers or mortgage bankers. S&Ls currently provide more than two-fifths of all home mortgage credit in the United States.

In 1969 only a little over 1 percent of the total loan portfolio of S&Ls was not secured by real estate. Even these non-mortgage loans, however, are closely related to their savings and home financing activities. Approximately 1/2 of such loans are secured by savings accounts, another 38 percent are home improvement loans, about 5 percent are educational loans, leaving only 7 percent for all other purposes including consumer loans.

Laws and regulations, including federal income tax statutes, limit rigidly the kinds of mortgage loans which may be held by an S&L. These restrictions are quite complex and frequently overlap but can be generally summarized as follows: No more than 20 to 25 percent of the assets of an association may be in loans secured by multi-unit dwellings and other investment type properties. The rest of the portfolio must be in home mortgage loans.

S&Ls advance the bulk of their funds as commercial loans. Over 75 percent of their loans are conventional, with less than 10 percent underwritten by the Federal Housing Administration or the Veterans Administration. Concentration on conventional loans can be explained by a number of factors. The long success with the monthly ammortized loan has undoubtedly reduced the interest of S&Ls in FHA mortgage insurance. Furthermore, S&Ls are local lenders with a thorough knowledge of real estate in their lending areas. The standardized underwriting procedures of FHA and VA sometimes fail to recognize local differences which S&Ls consider significant in appraising a structure.

On the practical side, processing delays associated with FHA and VA programs sometimes discourage S&Ls. More significantly, the fixed interest rates on FHA and VA loans have at times been unrealistic.

S&L funds placed in mortgage loans originate from four major sources:

- Net gains in savings,
- Mortgage loan repayment,
- Retained earnings, and
- Borrowed funds.

Since World War II the net gain in savings has been a major, if somewhat volatile, source of loanable funds. Generally, net savings have provided almost 1/2 the money available for mortgage lending.

MOBILE HOMES

The Housing Act of 1968 extended the ability of S&Ls to meet national housing needs by empowering them to finance mobile homes. FHLBB regulations permit S&Ls to invest up to 5 percent of their assets in mobile homes. To qualify for financing by a S&L, a mobile home must be at least 40 feet long and 10 feet wide, provide living facilities suitable for year-round occupancy with all the usual amenities of a traditional single family home. Loans may have maturities of up to 12 years for a new unit and 8 years for a used unit, and may cover close to the full cost of a unit.

S&Ls IN AREA DEVELOPMENT

S&Ls play an important but limited role in nonmetropolitan development. Capital for housing is both directly and indirectly related to overall needs for capital for economic development. Since housing is a critical element for total development in most areas, S&Ls have the potential to play an important role, particularly in those areas where the commercial banking system is not responsive to the demand for housing funds.

There are two areas where development organizations can work to increase the development role of S&Ls. The first involves their initial establishment. Many rural counties do not have any savings institutions other than the local bank. The Checchi study of capital in Central Appalachia suggested that a potential for new S&Ls exists in many rural counties of this depressed region.

Since there are no firm determinants for assessing the feasibility of a new S&L in regard to population, personal income and savings rates, the demand for housing at the local level should be the ultimate key factor. Obviously, many factors must be dealt with besides demand - local support, actual savings capacity, orientation to existing S&Ls in other counties, etc. In the final analysis, however, local initiative and support may be the key factor. In this regard, economic feasibility depends on political feasibility. Thus, development organizations could serve as a logical institution to investigate the need for and feasibility of establishing new S&Ls and where necessary, to mobilize local support for such endeavors.

The other area where development staffs can play a useful role involves the need for S&Ls to participate to a greater extent in federally insured housing loans. By promoting the use of federal insurance programs through their educational and information functions and through technical assistance to potential borrowers and lendors concerning paper work and eligibility, development agencies can play a leadership role in opening up these channels of housing credit in underdeveloped nonmetropolitan areas.

OTHER POTENTIAL LOCAL SOURCES OF CAPITAL

SMALL LOAN COMPANIES

Loan companies, or associations, normally are organized under and regulated by State Banking Commissions. Loan companies break down into two types: industrial loan companies and small personal loan companies. Neither can accept deposits and both generally have capitalization requirements tied to the size of the community. The permissible size and maturity of the loans and other conditions of operation vary from state to state.

- Industrial Loan Companies. Generally speaking, industrial loan companies are allowed to lend up to 10 to 20 percent of capital and surplus. A general estimate of average capital and surplus would be, roughly, about $100,000. Maximum permissible loan maturities range from two to ten years. Interest on the loan is normally deducted in advance.

- Personal Loan Companies. Small, personal loan companies are limited to loans of $600 and $800, depending on the state. Loan maturities are restricted to about two years. Loans are on an installment basis, and interest charges are pegged to the size of the loan; for example, 2-1/2 percent interest per month on the first $300, and 1-1/2 percent on the excess.

There are a large number of personal loan companies active in nonmetro areas. Though small, these companies have aggressively promoted the installment loan business and have carved out a significant financial role for themselves. They are incidental to the large problems of economic development, but they fill a need not satisfied by the established commercial banks.

CREDIT UNIONS

Credit unions are federally-chartered or state-chartered. Both serve groups having a common bond of association, occupation, or residence. Federal credit unions are chartered and supervised by the Bureau of Federal Credit Unions within the Department of Health, Education, and Welfare and make loans to their members for a variety of purposes. About 40 percent of the loans are made to meet personal, household, and family expenses, and about 45 percent are for purchasing durable goods, primarily automobiles. Maturities of loans are limited to ten years, maximum interest rate on loans to members is one percent per month on the unpaid balance.

Types of loans made in state-chartered credit unions are generally similar to those made in federal credit unions, although real estate loans are more prevalent in state credit unions. Interest charged ranges from one to one-and-one-half percent per month on unpaid balance, and the maximum amount that can be borrowed on an unsecured basis is $750.

Companies Rendering a Comprehensive Financial Research and Advisory Service

(1) Standard & Poor's Corporation
345 Hudson Street
New York, N. Y. 10014

(2) Moody's Investors Service
99 Church Street
New York, N. Y. 10007

Companies Rendering Financial Chart and Statistical Services

(1) M. C. Horsey & Company
37 Wall Street
New York, N. Y. 10005

(2) F. W. Stephens Company
P. O. Box A
Newfoundland, N. J. 07435

(3) Trendline Corporation
345 Hudson Street
New York, N. Y. 10014

(4) Studley, Shupert Statistics, Inc.
155 Berkeley Street
Boston, Mass. 02116

Companies Offering Business and Investment Advisory Services

(1) Alexander Hamilton Institute, Inc.
235 East 42nd Street
New York, N. Y. 10017

(2) American Institute for Economic Research
Greater Barrington, Massachusetts

(3) American Investors Service
88 Field Point Road
Greenwich, Connecticut 06830

(4) Babson's Reports, Inc.
Wellesley Hills, Massachusetts 02181

(5) International Statistical Bureau
350 Fifth Avenue
New York, N. Y. 10001

(6) Forbes Investors Advisory Institute, Inc.
60 Fifth Avenue
New York, N. Y. 10011

(7) United Business and Investment Service
210 Newberry Street
Boston, Massachusetts 02116

(8) Arthur Wiesenberger & Company
61 Broadway
New York, N. Y. 10006

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Baker Fentress & Co., Chicago, Illinois
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Citicorp Venture Capital Ltd., New York, New York
Commercial Capital, Inc., Covington, Louisiana
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Creative Resources Corp., Needham, Massachusetts
Daniel McGanney, Palo Alto, California
Data Science Ventures, Princton, New Jersey
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Delta Capital Inc., Slidell, Louisiana
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Dixie Capital Corp., Atlanta, Georgia
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First American Investment Corp., Atlanta, Georgia
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Kock Venture Capital, Cambridge, Massachusetts
Loeb, Rhoades & Co., New York, New York
Longwood Management Associates, Brookline, Massachusetts
Maiman Associates Inc., Los Angeles, California
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Memorial Drive Trust (A.D. Little, Inc.), Cambridge, Massachusetts
Mome Capital Corp., Thomson, Georgia
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Narragansett Capital Corp., Providence, Rhode Island
New Business Resources, Dallas, Texas
Northrop Technology Development, Inc., Los Angeles, California
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Ralph I. Straus, New York, New York
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Royal Street Investment Corp., New Orleans, Louisiana
Security Financial Management Corp., San Francisco, California
Sheber Rock Corp., (Wm. S. Paley), New York, New York

Smith Barney & Co., New York, New York
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Sutter Hill Capital Corp., Palo Alto, California
Tart & Legge, Inc., Rochester, New York
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The Island Co., New York, New York
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Venrock Associates (Rockefeller Bros.), New York, New York
Virginia Capital Corp., Richmond, Virginia
Weyerhauser Family, Minneapolis, Minnesota
William Blair & Co., Chicago, Illinois
Wm. A. M. Burden & Co., New York, New York

PART III

SOURCES OF PUBLIC DEVELOPMENT CAPITAL

Over the past fifteen years, the public sector has played an increasingly important role in financing area development. Beginning with the Area Redevelopment program of the early 60's, the federal government has committed billions of dollars in grants, loans and loan guarantees to help finance a great variety of development projects and services to improve the economic and social well-being of the nation's rural and nonmetropolitan areas.

During this same period, a majority of the states also initiated or stepped-up programs to help finance area development activities. Most of these state programs have involved industrial aid finance to attract industries and create jobs in nonmetropolitan areas. Some states, however, have gone one step further by initiating programs of state financial aid to their local governments to help finance the provision of vital public services which are crucial if new industry and new jobs are to be created in small towns and rural areas. In addition, over twenty states have provided for some form of state financial aid to areawide planning and development agencies to assist them in the planning, coordination and implementation of development programs.

In spite of this increased federal and state support, local governments have been increasingly hard pressed to raise the funds necessary to finance the ever growing demand for public services, and at the same time keep their tax rates at reasonable levels so as not to over burden local citizens and to provide an attractive climate for new industries. To keep pace, local governments have relied primarily on two sources of funds to finance public services - local property taxes and federal aid in the form of grants and loans. A 1970 study by USDA the Economic Research Service found that nearly three-fourths of the money to finance local services came from federal aid and the property tax.

Despite increased federal and state aid, local governments found it necessary to constantly search out additional sources of income to meet the rising costs of public services. Now, with new national priorities which stress fighting inflation, holding the line on federal spending, and increasing the responsibilities of state and local governments in the planning, managing and financing of domestic programs, additional and alternative sources of revenue are becoming even more crucial. No doubt general and special revenue sharing will help bridge some of the gap. However, state and local officials and development directors are already asserting that revenue sharing funds will not be sufficient. This session is designed to familiarize development personnel with up-to-date information on potential and available sources and techniques of financing area development to supplement their traditional reliance on federal grant-in-aid programs.

At the local level, the focus will be on public debt finance with emphasis on the development and use of general obligation and revenue bonds. At the state level, the focus will be on identifying and describing new and existing state programs designed to help finance development projects and services. At the federal level, those development programs which appear to have survived the current round of budget cuts will be emphasized, as well as the outlook for new federal grant and loan programs, particularly those authorized by the Rural Development Act of 1972.

LOCAL SOURCES OF PUBLIC DEVELOPMENT CAPITAL

INDUSTRIAL DEVELOPMENT BONDS

Industrial Development Bonds are issued by local government bodies (city, state, county, municipality, etc.) to buy or build plants and equipment to be leased to private enterprise. The most common variety of industrial development bonds are revenue bonds which are supported solely by rents derived from the facility. Some issues, however, have been general obligations which pledge the credit and taxing power of the issuer in addition to rents from the project.

The primary purpose of industrial development bonds is to attract new industries to areas by offering lower costs than would be incurred through traditional methods of corporate bond financing.

Since the interest on municipal bonds is exempt from Federal income taxes, local governments are usually able to borrow funds in the capital markets at interest rates lower than those available to private borrowers. An investor in the 50 percent income tax bracket would have to find a corporate bond yielding 6 percent before taxes for it to be as attractive an investment as a tax exempt municipal bond yielding only 3 percent, with comparable risk.

Typically, a municipality will sell bonds to purchase a site and build a plant for a particular company, usually to the company's specifications. It is then leased to the company for a period of time sufficient for rental payments to cover principal and interest on the bonds. Should the tenant default, he is subject to eviction, and another company is then sought to fill the premises. If the plant was financed by revenue bonds, any loss must be stood by the bond holders.

The first industrial aid bond was issued in the State of Mississippi in 1936. Authority for the issue came from Mississippi's then new "Balance Agriculture with Industry" plan which was state sponsored and legislatively approved, and made industrial aid financing available to all Mississippi communities.

Today only Mississippi uses general obligation bonds extensively, though Tennessee, Arkansas and Louisiana have made some use of this technique. Both revenue bonds and general obligation bonds are tax exempt, but they differ in the credit standing behind the issue. Since general obligation bonds pledge the full faith and credit of the municipality they have the advantage of being easily marketed. However, most states limit the amount of local bonded debt to the value of local property. Communities are often restricted to small scale financing and one issue may exhaust the possibility of further general obligation financing for many years.

In the past, four states--Arkansas, Mississippi, Alabama and Kentucky--accounted for 80 percent of total industrial development bond financing.

Revenue Bonds

Revenue bonds are marketed on the basis of the company's credit ratings and are limited only by the record of the company for which they are issued. As a result, revenue bonds are more effective in financing the expansion of well known firms with solid credit ratings, rather than for financing new firms.

The use of revenue bonds is based on the theory that potential customers of the service offered should discharge the indebtedness such projects incurred. Revenue bonds could be used, therefore, in lieu of increased municipal taxation. Moreover, municipalities were able to overcome borrowing limitations imposed by constitutional restrictions on general tax indebtedness.

During the 1930's the Federal Government was particularly anxious to have authorities created for housing construction and encouraged the states to allow the issuance of revenue bonds. Agencies of the Federal Government acted as underwriters of the issues, purchasing the revenue bonds and subsequently reselling them to private investors. With a market assured, municipalities and political subdivisions stepped up their use of these bonds.

Most states have statutes to control the issuance of revenue bonds. These statutes state that the bonds do not enjoy the full faith and credit and taxing power of the government; that they are not general obligations of the issuing governmental units; and that interest and principal on the bonds will only be paid from revenues earned by the project. The statutes usually require publication of financial statements at prescribed times and use of uniform accounting systems.

In states that allow revenue bonds to be issued, the immediate authority for such an issue comes from a city ordinance, or, if other political bodies are involved, from a resolution.

Growth of Industrial Development Financing

Of all government sponsored plans to aid industry, industrial development bond financing has become the most popular type of state and local industrial financing. The revenue bond has emerged as by far the most popular of the bond programs. Their popularity can be attributed to the fact that they require no pledge of community credit and hence are not limited as are general obligation bonds. The revenue bond is limited in its use to those companies with good credit ratings for this is the basis upon which the bonds are marketed.

Typically, revenue bond authority permits a locality to sell securities in order to obtain funds to erect an industrial building. The rentals from the lease of the building should be sufficient to service the debt. While in some cases state and local tax exemption has been obtained, the principal objective of the revenue bond is to provide interest income which is exempt from federal income taxes, thereby lowering the cost of capital by as much as a full percentage point to the new industry.

The growth and success of industrial revenue bond financing made this a controversial topic in the late 60's. In 1968 Congress passed legislation limiting the size of issues eligible for tax exempt status of $5,000,000. Moreover, the legislation also prohibits public financing support of large projects by limiting the capital spending of the recipient firm to a total of $5,000,000 in any one location over a period of three years before and three years after the issue. In addition, the SEC issued a ruling requiring issues of industrial revenue bonds over $300,000 to be fully registered. This regulation added significantly both to the time and the costs involved in floating public revenue bond issues. Finally, legislation passed as a part of the Tax Reform Act of 1969 reduced the tax advantage to be gained from the purchase of new bond issues. (Presently these bonds can be used to finance anti-pollution facilities with no limit to the amount of the issue.)

Since these limitations have been placed on the bonds, they have eliminated the controversial large issues of over $5,000,000. However, their use is still very popular for the smaller issues that are eligible under the Act. As of October 1971, 43 states permitted local governments or development agencies to issue bonds for industrial development. In some states, however, only certain communities are authorized to issue bonds.

STATE DEVELOPMENT FINANCE PROGRAMS

INTRODUCTION

Direct state financial support for area development most often takes the form of industrial aid financing programs. Statewide financing plans developed so rapidly in the late 50's and early 60's that now only 3 states - California, Arizona and Idaho - are without such aid. Thirty-nine states have credit development corporation laws, 14 states allow general obligation bonds, 44 have legalized revenue bond plans, and 10 have mortgage guarantee authorities. Most of these states have programs which include more than one financing technique. In fact, a number offer 2 or 3 plans and five states have four different financing techniques available to aid industry.

Municipal bonding and business development corporations, two key elements in many states' industrial aid financing plans, are discussed in other sections of this course. This section deals with state loan and loan guarantee programs to support business and industrial development.

DIRECT STATE LOANS

As of 1971, fourteen states had set up authorities to make direct loans to industry. These authorities obtain their funds from general fund appropriations or from bond issues authorized by the state government. The state authority participates with local industrial development corporations and conventional lenders in making long-term loans to industry. These state funds are usually made available at a low rate of interest. The New York Job Development Authority borrows funds at low interest rates through its special tax status and relends the money instead of relying on state appropriated funds.

THE PENNSYLVANIA PLAN

Pennsylvania's direct loan authority accounts for the largest dollar volume of industrial loans among the states. The New York authority, a newcomer, accounts for one-half of all the lending capacity authorized. New Hampshire, Oklahoma, and Kentucky have also made modest use of this technique.

The Pennsylvania approach is the most common form of state industrial aid finance. The objective of this approach is to make better use of existing private sources of funds while at the same time providing a means of supplementing private credit with public funds. This approach assumes that, although untapped sources of private credit exist, private credit is insufficient to meet all the credit needs of new industry in the state.

Under the Pennsylvania plan, the State Industrial Development Authority is authorized to make loans to local nonprofit industrial development corporations for part of the cost of constructing industrial plants. In return for such a loan (which has been raised to 40 percent of the total cost), the State Industrial Development Authority receives a second mortgage on the facility. The local industrial development corporation must raise the rest of the funds necessary for the facility from private sources of credit and through local subscriptions to the development corporation. Normally, 50 percent of the funds must come from private sources in return for a first mortgage on the facility and 10 percent must come from local subscriptions.

This plan eliminates some of the problems associated with the other subsidization plans. It does not involve the Federal tax-free treatment of interest on state and local bond issues and the new plant is not automatically exempted from the local property tax. Another advantage of the plan is that it requires the people in the area in which the plant will locate to contribute directly toward the financing of the facility. This places some of the cost of the expansion on the area receiving the greatest share of the benefits. A final advantage of the plan is that it cannot adversely affect the credit rating of the local government.

It must be noted, however, that this plan does not provide as great a financial incentive for location of a plant in a given area as do industrial development bonds. It appears that if the sole consideration in the location of a new industrial facility is the cost of the location, the Pennsylvania plan is less attractive to firms than a program making use of industrial development bond financing.

Although the Pennsylvania plan does not deal directly with the problem of the high cost of investment funds, it does reduce the amount of funds which must be obtained directly through the private sector, and this in turn reduces the interest cost of the financing.

This approach might be extremely effective in providing for the financing needs of firms just entering business, which typically are already tied by noneconomic factors to an area.

THE OKLAHOMA PLAN

A variation of the Pennsylvania plan, first used by Oklahoma in the late 1950's, also establishes a State developmental authority with the power to make second mortgage loans to local development corporations for industrial development projects. In this case, however, the authority obtains its funds from general obligation bonds, not from the State general fund. Aside from this difference in the source of funds there are no major differences between the two programs.

The change in the source of funds does make several significant changes in the advantages and disadvantages of the plan. The use of general obligation bonds again raises the question of whether or not the Federal tax exemption of interest on State and local bonds should be used to encourage industries to locate in a certain section of the country.

An advantage of the plan is that it eliminates some of the problems associated with limited State tax funds. Because bonds are used, States are not required to use State general fund money to finance local industrial development. Instead, development is financed through outside sources. This is an important advantage, especially for those States which would have difficulty in supporting a full-scale industrial development program if all revenue for the program had to come from their general funds.

The Oklahoma approach is also used by New York, Maryland, New Hampshire, and Alaska. Oklahoma, New York, New Hampshire and Alaska have had the greatest experience with this program.

THE LOAN GUARANTEE PLAN

A third alternative to the use of industrial development bonds was developed in Maine. This plan, while based on the view that the major barrier to local industrial development is inadequate local credit for industrial construction projects, attempts to more fully utilize existing private sources of capital while at the same time keeping to a minimum public expenditures in this area.

The plan has as its local base of operation a nonprofit industrial development corporation similar to those established under the Pennsylvania plan. Under a loan guarantee program, however, the local industrial development corporation is financed solely through private sources. The industrial development corporation decides which projects will receive assistance and provides the approved projects with the necessary financing at a standard rate of interest. The State participates in this action by insuring the repayment of up to 90 percent of the loan. For this it receives a service charge of one quarter of one percent or more of the loan. If the State must repay the loan, the funds come from the State general fund.

The loan guarantee program combines some of the advantages of the industrial development bond program with the advantages of the development finance authority. Its special advantage is that the actual outlay of public funds for a project is very small while at the same time the questions of equity associated with the use of bonds are not raised. Like the industrial finance authority, the local industrial development corporation can provide information for small businessmen on sources of investment capital. In addition, often after the State loan guarantee agency has indicated a willingness to guarantee loans from local industrial development corporations, private sources that had initially rejected the loan are willing to participate in financing the project. From the point of view of the commercial bank or other institutional lenders, the guarantee feature makes it possible to make legally a larger mortgage on the assets, and the mortgages are more resalable.

It might also be argued that this plan provides a better pairing of the costs and the benefits of economic development than either the industrial development bond plan or the second mortgage plan. Here almost the entire financial responsibility for economic development falls on those in the area where a majority of the benefits accrue.

Again the question of the effectiveness of the program arises, however. If the local credit system in an area is inadequate to deal with financing the expansion of an industrial plant, the plan would be of no help since funds for construction would not be available no matter how sure the investment was.

In those areas where the problem is not one of a lack of private credit, but only a lack of private credit willing to invest in risky ventures, the plan would appear to have possibilities for success. This plan also might be able to provide financing for new firms more successfully than any of the other programs, although experience has shown that this type of loan goes predominately to established firms desiring to expand their operations.

SUMMARY–STATE LOAN AND GUARANTEES

Several studies have concluded that state industrial aid finance programs which help reduce interest costs have little influence on firm investment decisions. However, the availability of funds was found to exert an influence on the investment decisions of most small firms and some medium-size firms. On the other hand, larger firms seem virtually unaffected by state financing programs.

Both the direct loan and loan guarantee programs appear to have more influence on a firm's decisions about the size of an investment than on the choice of a state or an area in which to invest.

Furthermore, state loan and loan guarantee programs seem to have been more successful in providing the state's existing plants with more efficient capital equipment or a more comfortable working capital position than in making a state better able to compete for new plants.

Loan guarantee programs have little to offer large firms since savings in interest costs are too small to be critical to most large firm's locational decisions. Thus, they primarily benefit small high risk manufacturing firms. In this way, the program can on occasion make a significant contribution to regional economic growth by reducing the credit gap for risk loss and thereby perfecting the capital market.

A loan guarantee program does not compete with but rather compliments the conventional long-term industrial mortgage market. It provides a pooling mechanism to overcome the difficulties of financing relatively specialized industrial properties or those built in small communities with no extensive market for resale in case of default.

BUSINESS DEVELOPMENT CORPORATIONS (BDCs)

BDCs are an important source of development capital in many states. Sometimes referred to as Development Credit Corporations, this unique form of financial organization is designed to lend money to spur industry and business development rather than to make a profit. BDCs obtain capital from the sale of stock to banks, insurance companies, other business firms and individuals. They may, however, lend many times their stated capital by borrowing from member financial institutions. BDCs are set up to make credit available, through risk pooling, to businesses which cannot obtain it from conventional sources. Such corporations are generally more flexible than other public sources of industrial financing, because they can lend money not only for land and buildings, but also for such purposes as machinery and equipment, working capital, inventories and debt retirement.

The BDC movement originated in the New England states in the 1950's and has spread rapidly. As of 1972, a total of 27 BDCs were operating in 25 states. In addition, statutory authority for similar corporations exists in 14 other states.

BDCs are organized by each state under a special charter which in effect exempts commercial lending institutions from normal lending statutes and permits them to lend a small portion of their assets to a Business Development Corporation. Commercial banks provide the backbone of support for the movement and comprise three-fourths of the lending members. The rest are chiefly savings banks, savings and loan associations, and insurance companies.

These lending organizations in the state thus pool the risk on loans that have industrial growth potential but would not ordinarily be granted by private commercial lenders acting alone. Loans of this type are usually made to growing firms that are too small or too young to get long-term financing from insurance companies or other lenders, or whose owners do not wish to sell part of their equity.

Business Development Corporations thus induce location of industry or encourage expansion of facilities in their particular states by providing loans which, if available at all, would otherwise be at prohibitive rates. Interest rates of commercial financing companies would be at least twice as high, and could not always be obtained. This "subsidy" in the form of saving of high interest cost involves no expenditure of state funds.

BDCs normally make only long-term loans without taking equity in the portfolio company. Most BDCs take substantially more risk than a bank or insurance company. Normally the money lent is somewhere between venture capital (equity) and institutional money, but equity investments are sometimes made.

Since there is usually little return, no capital gain, and no liquidity, common stock is sold primarily to larger institutional investors whose capital base is built into the state's economy and will thus benefit indirectly from economic growth.

While BDCs are by design not primarily profit seeking vehicles, they must make some money to permit modest growth in capital and insure their survival. Usually there is little or no promise to pay anything but token dividends, although a few are successful enough to pay more if they so desire.

Most established BDCs have a solid base of stock, retained earnings and reserves, forming a comfortable cushion–usually about 20 percent of outstanding loans.

Typically, BDCs still finance primarily established in-state manufacturing businesses. It should be noted, however, that as of 1972, 20 percent of their loans went to recreation and service industries reflecting a response to these rapidly growing sectors of the economy.

Although BDCs have been criticized in the past for not taking enough risks, their loan standards are by no means conventional. Since BDCs are not designed to compete with commercial banks but to provide supplemental financing for growth firms whose needs are not bankable, only by assuming greater than ordinary lending risks can a BDC stimulate economic development.

Another function the BDC serves is to make loans feasible for commercial banks and other private lenders by enabling private lenders such as banks and insurance companies to make loans because of the availability of risk money from BDCs. Furthermore, as BDC loans prove successful, they are often purchased before maturity by members of the banking community.

BDCs and similar financing organizations can also be organized on an areawide basis. As of mid 1972 only one state–Pennsylvania–had organized BDCs on a substate regional basis. More recently the 8-county Kentucky River ADD in Eastern Kentucky has organized a district development fund similar to a BDC. The fund, a nonprofit corporation with an initial capitalization of $50,000 put together by 10 banks in the area, is designed to provide more liberal financing terms than otherwise possible in the form of higher risk lending, longer maturity and lower interest rates.

SUMMARY

Many knowledgable people believe that BDC's are extremely helpful in encouraging internal growth of smaller firms. By incurring risks and charging enough to cover costs, they aid in expansion of firms whose growth might otherwise be stunted. Thus, through only some cost to initial stockholders, BDCs provide an effective tool for economic development. Their apparent effectiveness is illustrated by their rapid spread throughout the country. Their viability was proven during the easy money period of 1970-71 when BDCs as a group survived comfortably even though regular commercial lenders were out looking for business and taking extra risk loans that supposedly are in the BDC jurisdiction.

DEVELOPMENT CREDIT CORPORATIONS*
QUESTIONS AND ANSWERS

1. Q. What is a Development Credit Corporation?

   A. It is a private company authorized by State law to financially assist existing and new business enterprise within the State.

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*New Mexico Department of Development, *Development Credit Corporations-1970.*

2. Q. Does New Mexico have such a law?

A. The Statute was enacted in 1965 and amended slightly in 1967.

3. Q. How is a Development Credit Corporation financed?

A. The funds with which it operates are provided from two sources:

1. By the sale of capital stock to public spirited corporations–which in many states include virtually the entire business community.
2. Banks, Savings and Loan Companies, and Insurance Companies become "members" of the corporation and pledge to make loans to the corporation on a pro rata basis.

4. Q. How is the size of such loans determined?

A. A formula based on the capital and surplus of each institution is spelled out in the law and in the articles of incorporation.

5. Q. Who selects the directors of the corporation?

A. The law provides for nine, twelve, or fifteen directors one-third of whom are elected by the stockholders and two-thirds elected by the "pool" members.

6. Q. Are the directors paid?

A. Generally the directors serve without recompense. The only persons paid a salary are the full-time staff members.

7. Q. What type or kind of loans would a Development Credit Corporation make?

A. Although it is a private corporation its fundamental purpose is to produce employment and improve the economic well-being of the State. The basic criteria for making a loan is based on these factors plus prudence and the borrowers capacity to fulfill his commitments.

8. Q. Does a Development Credit Corporation compete with conventional lenders?

A. No. It is usually written into the by-laws that the potential borrower must have been turned down by at least one conventional financial institution to be eligible for consideration.

9. Q. How can a Development Credit Corporation make loans the conventional institutions turn down?

A. Unlike conventional financial institutions, Development Credit Corporations do not have to face such considerations as deposit withdrawals and payments to beneficiaries of insurance policies. Also the potential risk is spread broadly throughout the lending pool member institutions.

10. Q. How does such a corporation help the State?

A. Its loans to developing industry stimulate economic growth, increase employment, reduce welfare roles, broaden the tax base, and have many collateral economic effects such as increased bank deposits, greater consumption of consumer goods, and larger demand for utilities and insurance coverage.

11. Q. Do financial institutions ever participate with Development Credit Corporations on loans?

A. It is a regular and constant practice in all states having such a corporation. Frequently a financial institution will buy a matured loan from the Development Credit Corporation.

12. Q. Can Federal funds be obtained to increase the loaning capacity of the Development Credit Corporation?

A. Under the Small Business Administration's "501" program, a Development Credit Corporation can borrow an amount equal to the total amount borrowed by the corporation from all other sources.

13. Q. How is a Development Credit Corporation different from a Small Business Investment Corporation?

A. By design and nature a Development Corporation is more public spirited. Its funds are raised from entirely different sources and it is not seeking capital appreciation from its financing activities.

14. Q. What are the terms and conditions of loans made by a Development Credit Corporation?

A. All details of loaning practice are determined by the law and the elected directors.

15. Q. Is it likely a dividend will be paid on the capital stock?

A. A capital stock investment should be considered long term. Under New Mexico law a Development Credit Corporation must set aside a surplus of not less than 50 percent of its net earnings each year until surplus equals at least one-half of its capital stock.

16. Q. Is there any supervision of a Development Credit Corporation by State authority?

A. Under the law a Development Credit Corporation is subject to examination and supervision by the Commissioner of Banking.

OTHER STATE DEVELOPMENT FINANCE PROGRAMS

In the past few years a variety of new development finance programs have been put into effect by several states. For example, twenty-seven states now provide tax incentives, to industries for compliance with pollution control laws. Some states have adopted a statewide bond program to assist local communities in matching federal grants for waste water treatment facilities.

Other states have initiated state programs to assist local governments in the development and packaging of municipal bonds. For example, in Vermont a state Municipal Bond Bank has been established to pool a number of small local issues into a single state-sponsored issue backed by the taxing powers of the local governments and a state reserve fund. This procedure yields interest rates far lower than single-issue borrowers with lesser credit ratings can obtain. The bank was established by the state legislature to encourage local governments to undertake public improvements. While the bonds are not backed by the credit of the state, the legislature is authorized to appropriate funds to meet debt service deficiencies.

Although municipal industrial bonds have been specifically excluded under the Vermont program, such "bundling" of small issues by state authorities creates a mechanism for tying in the capital needs of small businessmen and local governments with national capital sources.

Several other states have taken an active role in local government debt administration. A number of states review proposed bond issues of local governments and offer technical assistance in marketing bonds. In North Carolina, however, the state actually conducts the sale of local bond issues. A Local Government Commission, which functions as a division of the Department of the State Treasurer, supervises all aspects of the debt issuance process.

Before any local unit may issue bonds or notes it must file an application with the Commission requesting approval of the proposed issue. In actual practice, the decision for approval is made prior to formal submission of an application. A local official contacts the Commission office, provides information concerning his proposed financing, and then meets informally with the Secretary or his designated assistant to discuss the feasibility of the proposed bonds. If the Commission's staff has doubts about the marketability of the bonds, suggestions will be made to the local unit on possible changes designed to strengthen the proposal. If these changes can be made, then the issue will likely be approved by the Commission. If the issue still seems infeasible in the view of the Commission, then the local unit will usually discontinue plans for issuing the proposed bonds. In general, the Commission examines the necessity and expediency of the bonds or notes as proposed, the adequacy of amount, and the ability of the issuing unit to make repayment.

There are numerous advantages to this procedure. First, the state staff knows and understands the market and how it responds and reacts to North Carolina issues better than any one of the more than 600 local units could possibly understand, working independently. They know insofar as possible the better times to sell to obtain the most favorable interest rates.

RECENT DEVELOPMENTS IN THE STATES

In 1972, several state legislatures passed laws which are of potential significance to nonmetropolitan development. For example:

- Maine established a system of Municipal Bond Banks to provide adequate capital markets and facilities for borrowing by local governments to finance public improvements.
- The Georgia legislature passed a Business Development Corporation Act which authorizes all financial institutions to become members of, and make loans to, the corporation when called upon to do so.
- An amendment to the Georgia constitution passed last November created a new method of state debt financing and a State Financing and Investment Commission.
- Mississippi enacted the Small Businessmen's Loan Assistance Act, which is designed to encourage small business loans by furnishing lenders additional security.
- Tennessee created an industrial development authority which is authorized to guarantee loans for industrial development projects. The Authority may also purchase first mortgage industrial loans initiated by commercial lending institutions.

LEEWAY INVESTMENTS FOR SOCIAL PURPOSES

One of the more important new developments in state legislation concerning development finance concerns the passage of laws allowing banks and other financial institutions to invest in "leeway" securities. Generally speaking, these laws authorize banks to invest up to 2 percent of their assets in "social purpose" investments which contribute to the public welfare by facilitating the provision of a service or facility needed by the residents of the area. Indiana went so far as to allow banks to make equity investments in corporations organized for such purposes.

This state legislation on leeway investments has been brought about by two developments. First, last August the FDIC issued new guidelines which in effect ordered their bank examiners to broaden and liberalize their interpretations of loans made by banks to corporations which are not merely private and entrepreneurial, but whose objectives and purposes are primarily of a civic or community nature. In other words, the FDIC has given banks more leeway to make loans for such purposes, thus easing bankers' fears that such loans would be classified as bad risks by FDIC examiners. The FDIC's new policy on leeway securities is similar to one issued by the Comptroller of the Currency in 1971 allowing national banks to make such investments in community development projects.

The other development which has led to the passage of these state laws is the Minbanc program created by the Amercian Bankers Association. The Minbanc Capital Corporation is a closed-end investment company whose primary objective is to make capital funds available to qualifying minority owned banks to enable them to contribute to the growth of their community. Shares in the corporation are being offered exclusively to banks which are members of the ABA.

Although banks are now authorized by the appropriate federal regulatory agencies to make leeway investments for social purpose objectives, state chartered banks cannot do so unless specific authorizing state legislation is passed. Thus in 1972, five states passed legislation on leeway investments. While the FDIC allows banks to invest up to 10 percent of their assets in such loans, most state laws have set a 2 percent limitation.

Further information on recent state legislation in this area can be obtained from the ABA's Office of State Legislature Council in Washington. Information on the Minbanc program can be obtained from Peter F. McNeish, Director of the Urban Affairs Committee of the ABA in Washington.

SMALL BUSINESS ADMINISTRATION

Local bankers in areas remote from the major financial centers are often reluctant to make long-term or high-risk loans, even at the markets' established premium for such loans, because the cost to the small bank of hedging liquidity and risk is unprofitably high under the banking laws. On the other hand, the larger city banks that have the intermed resources for long-term or high-risk loans are reluctant to make small loans outside their more-easily-supervised home territory.

The principal Federal alternative source of funds is the Small Business Administration (SBA), created to assist economically-viable enterprises that are to reach the capital market on decent terms. SBA, an independent agency, provides financial, managerial and government procurement assistance to small business concerns - a category that also encompasses virtually all local development companies and community development corporations. Generally, SBA funds are available only to firms which cannot obtain adequate financing from private lending institutions. Yet, SBA's loans must "be of such sound value or so secured that repayment will reasonably be assured," a stipulation which has been interpreted by SBA as requiring collateral whose liquidation value would cover the SBA loan. Although SBA can supply any portion of project costs consistent with the collateral requirement, the maximum term for direct loans is ten years, as opposed to a longer term. Since a new venture can seldom provide the required collateral, and usually needs longer-term credit, SBA's function has principally been to supply working capital to established enterprises. However, SBA can make twenty-five year loans indirectly through local development agencies.

SBA financing comes through five major channels. The SBA itself grants long-term loans at below market rates. It may also guarantee bank loans made at rates up to two percent above the prime rate. Third, it will lend to small business investment companies (SBICs) by matching private capital at varying multiples (these companies, organized for profit and licensed and regulated by the SBA, make debt and equity investments in small businesses). Fourth, local development companies, private corporations not operated primarily for profit, may receive long-term loans to finance plant construction for small business. Finally, the SBA lends to state development companies, organizations specially chartered by state legislation to invest in small businesses.

Lease and Surety Bond Guarantees

Significant non-loan assistance programs of the SBA include lease and surety bond guarantees:

- **Guarantees** The lease guarantees program is designed to provide prime space for those small business firms which cannot compete with perspective tenants with AAA ratings. In order to make the program self-sustaining lessees pay an insurance premium based on sound actuarial computations, but not in excess of 2-1/2 percent of the lease amount. It is estimated that 700 commitments for an aggregate rental guarantee of $250 million will be made in FY 1974.

This insurance program guarantees the payment of rent under new leases on real property entered into by small businesses. The lessor is the beneficiary of the lease guarantee insurance. Any person or entity may be the landlord, however, financing for the facility to be leased cannot be from tax-exempt sources and no affiliation can exist between the landlord and the tenant. The lease must reflect a true landlord-tenant relationship. The maximum amount of aggregate contract rental under one lease that can be guaranteed directly is the lesser of $15,000 in any month or $2,500,000 in the aggregate over the term guaranteed. The minimum term for guaranteed leases is 5 years, and the maximum is 20 years. SBA can guarantee directly without participation by private insurers leases with a minimum term of 10 years and a maximum term of 20 years. The minimum term of a lease for participating insurance companies is 5 years.

Lessee small businesses may file their application with a private insurer or SBA Form 800-A, Part I. Lessors may file their application with a private insurer or SBA directly, using SBA Form 800-A, Part II. Required supporting information is listed on the forms. SBA reserves the right to inspect the operations and audit the books of the lessee.

- **Surety Bond Guarantees** The surety bond guarantees program is designed to assist small contractors in obtaining a larger share of municipal, State, Federal, and private contracts. SBA will guarantee reimbursement of up to 90 percent of the leases sustained by a surety company as a result of the issuance of a bid, payment, and/or performance bond to a small business concern on a contract up to $500,000. It is estimated that surety bond guarantees will be made in connection with 4,000 contracts totaling $280 million in FY 1974. The average contract size in the past has been estimated at $80,000.

SBA cannot guarantee a bond on any contract whose face value exceeds $500,000, nor will they guarantee a bond for any contractor who had more than $750,000 in gross annual receipts for the past fiscal year or whose receipts averaged more than that amount over the last three fiscal years. This size standard is lower than for other SBA programs, but has been established to reach the segment of small business intended as evidenced by the limit of $500,000 on any one contract.

Bond guarantees, a type of loan guarantee, for surety companies are meant to make the bonding system more available to those small contractors who, for various reasons, may have been denied access to that system.

Small contractors must apply directly to an insurance agent for bonding. The insurance agent must in turn contact a surety company to process the application. The surety company then deals directly with SBA in a guarantee situation.

Small Business Investment Companies-An Overview

Small Business Investment Companies (SBICs) are privately owned for-profit operations which make long-term equity or debt investments (minimum financing period of five-years) in small business concerns. They are organized under state law for the sole purpose of providing, under SBA license, equity and long-term debt financing to small businesses in a defined area. The most important benefit derived from the formation of an SBIC is the quite substantial amount of additional money (some on very favorable terms) which can be leveraged by the private capital initially put up by investors at the time when the SBIC submits a license application to SBA.

If an SBIC can raise at least $150,000 in private capital, such a corporation will be eligible for SBA licensing and a long-term loan of twice the amount of private capital, up to $7.5 million (by statute, SBA must require that at least $150,000 in private capital be invested in the SBIC before a license is issued to it). Once SBA has issued the licence, SBA is prepared to purchase debentures from the SBIC up to an amount equal to twice the SBIC's private capital (thus, an SBIC capitalized at the minimum amount required is able to sell debentures to SBA resulting in an investment capital available to it of $450,000). The terms of the debenture are extremely favorable, and are very likely the deciding factor in the formation of an SBIC, both because of the favorable terms and because of the additional funds which may be leveraged. Presently, the terms of the debentures is ten years with the principal due only at the end of the term in one enormous balloon payment; the interest rate, geared to the rate at which the treasury can borrow money, is currently 5-1/2 percent.

The low profitability of SBICs with less than $300,000 private capital (0.4 percent return compared with 9.5 percent return average for all SBICs) has made the SBA reluctant to assist them. And, although several provisions facilitate SBIC financing of business in low income areas, none seems to provide a significant incentive for such investment given the for-profit nature of SBICs. In deciding whether the formation of an SBIC looks sufficiently attractive to merit serious consideration, a community group should keep in mind the several substantial disadvantages involved. First of all, the group should be aware that if the SBIC is capitalized at or near the minimum $150,000 required by SBA, it will in all likelihood go bankrupt unless it obtains outside subsidy (the total revenues will most probably be insufficient to meet administrative expenses let alone provide for principal repayment on the SBA debenture). In addition, the SBIC cannot, without prior SBA approval, use more than twenty percent of its paid-in capital and surplus to finance any one small business concern and its affiliates, nor can it control, except on a temporary basis, the small business concerns to which it provides financing. Similarly, not more than one third of its investments may be in one industry. Finally, under SBA's fairly rigorous conflict of interest rules, unless the community group were to establish the SBIC so that it owned less than ten percent of its stock and so that none of its officers or directors served the SBIC, the group would be able to assist any of its other businesses through the SBIC without SBA approval. These conflict rules could pose problems for low-income rural communities, which often do not have an abundance of persons who are qualified to serve as officers and directors of business enterprises, since it is likely that the persons who are best qualified to hold positions in the SBIC would be involved in enterprises which the SBIC might wish to assist.

Despite these disadvantages, use of an SBIC might be preferred over other sources of SBA financing because it can provide equity capital and does not require SBA approval of individual investments. Although, normally, conflict of interest rules forbid an SBIC to finance businesses which directly or indirectly control, are controlled by, or are under joint control with the SBIC (and an SBIC may not control an assisted business), an exception to the control rule may be made if "reasonably necessary for the protection of the SBIC's investment and an enforceable agreement to divest control within up to seven years exists. Approval of such arrangements apparently has been given routinely. Seven years may well be an acceptable deadline for organizations which plan to spin off their businesses to area residents. Thus, an SBIC might be integrated into an area development organization's structure by being owned by a community-based nonprofit (or for-profit) corporation and itself owning community businesses.

Local Development Companies and Section 502 Loans-An Overview

A local development company (LDC), like an SBIC is a private entity which can receive SBA-leveraged funds to assist small businesses. Under its section 502 program, SBA is authorized to make loans, or guarantee up to ninety percent of the amount of loans made by banks, to LDCs. LDCs which are incorporated under general state corporation statues, either on a for-profit or non-profit basis, for the purpose of promoting economic growth in a particular community or area within the state may receive such assistance.

The LDC must, as its primary purpose intend to benefit a particular target area or community through increased employment and business volume. Unlike the SBIC program, the SBA funds–Section 502 loans–may be used only for the construction, expansion, or conversion of commercial and industrial facilities, including the acquisition of land, as well as the cost of machinery and equipment. An LDC may construct the fixed assets itself and either sell or lease them to a small business, or may relend to the small business for the permitted use. Unlike loans to an SBIC, loans to an LDC are approved only for specific small business investments, and the maximum SBA participation in any one project may not exceed $350,000 for each small business assisted. The SBA will match private funds with long-term low-interest loans at a ratio as high as nine to one, up to the limit of $350,000 for each small business assisted. The maturity of the loans may vary with the type of collateral offered, however the maximum term is twenty-five years plus construction time.

Private sector participation in section 502 loans to and through state-chartered LDCs has been stimulated through utilization of SBA's first mortgage loan plan and loan guarantees. Conventional and institutional lenders are attracted primarily to the first mortgage loan plan, which permits a lender to participate in the financing of a project and to secure his exposure with a first mortgage on all fixed assets acquired with total project funds. A minimum of government red tape is involved, and the loan can be consummated substantially on the lender's terms. However, the infusion of SBA direct dollars at 5-1/2 percent interest on a second mortgage basis usually reduces the effective interest rate on the total project financing to the prime interest rate or lower.

The 502 program permits an LDC to retain title to project assets and to lease facilities to qualified small business concerns. As a landlord, the LDC can provide management assistance to the entrepreneur and thereby strengthen the tenants' operation. In those cases where tenants fail in their business effort, new tenants can be substituted. An LDC is much easier to amalgamate into an area development organization than an SBIC. The SBA sees the primary function of LDCs as community benefit rather than private profit.

State Development Companies and SBA Section 501 and 502 Loans-An Overview

State development companies are private or public corporations chartered by special legislative act to operate on a statewide basis. SBA lends funds to state development companies for general use purposes under its section 501 program and for plant construction, conversion, or expansion, including the acquisition of land, under its section 502 program. To qualify for either SBA program, a state development company must be incorporated under a special state law with authority to assist small business throughout the state. There may be more than one state development company in a state (Pennsylvania has four).

PART IV

FINANCING PUBLIC/PRIVATE SPONSORED AREA DEVELOPMENT PROGRAMS

There exists across the nation a variety of techniques and structural mechanisms to provide capital for development at the local or areawide level. These techniques and mechanisms are usually designed to meet local needs for equity capital and long-term unsecured loans for new business enterprises, loans for industrial and commercial land and buildings, and the delivery of socially-oriented services. When these techniques for raising capital are effectively managed, they should provide local or areawide development agencies with the capability to:

- Leverage local dollars with "outside" dollars,
- Attract local investment funds from local business and industry and from both high and low income residents of the area,
- Attract local investment funds from area citizenry, businesses and financial institutions to be combined with federal and state funds to finance a variety of social welfare needs such as low-income housing, health services, child care programs, manpower training, and services to the aged and indigent.

While various forms of locally controlled and operated financing entities exist in many rural and nonmetropolitan areas, few areas, if any, have attempted to create a total financing system.

Satisfying the diverse needs for capital listed above requires an interrelated financial structure rather than a single entity. To provide total financial services, several independent entities should be organized to function under a centralized management system. The most logical institution for coordinating the management of these separate entities in most nonmetropolitan areas will be the state designated substate planning and development agency.

The kinds of organizations needed to provide capital for nonmetropolitan areas include:

- Small Business Investment Corporations (SBICs),
- Regional (areawide) or Local Development Corporations,
- Community Development Corporations,
- Business Development Companies, and
- Housing Development Organizations.

These financial entities should, where feasible, be organized, capitalized and managed as a single interrelated system with each component contracting for services with an areawide management entity - perhaps organized as a non-profit "shell" corporation.

The overall functions of this financing system should be to provide three commodities to the area served:

- Money otherwise unavailable,
- Technical assistance, including communications and liaison, and
- Promotion and motivation.

The details of organizing, financing and managing these entities are set forth in the following pages. In addition, a detailed case study of the organization and operations of an areawide SBIC serving a nonmetropolitan area will be presented in lecture form. From this discussion and the written materials which follow, development leaders should obtain a better grasp of how they can structure a total financing system to meet the needs of their particular area.

LOCAL DEVELOPMENT CORPORATIONS*

Local development companies or corporations (LDCs) are enterprises incorporated for the purpose of furthering the economic development of a community or area. Their principal function is to finance the purchase of land and the construction of buildings or additions to existing buildings. In some states there are three types of development companies:

- Those privately financed through the sale of stock and operated for profit,
- Those privately financed through the sale of membership certificates and/or by contributions and operated nonprofit, and
- Those municipally financed through the sale of revenue bonds.

Depending upon their charter, LDCs may have authority to promote and assist the growth and development of small business concerns within their areas, and, in some cases, they may assist in acquisition of machinery and/or equipment. Fixed assets can be made available to the businesses being assisted by a lease, a lease with a purchase option, a conditional sale contract, or by direct loan of funds. In some areas local development companies have been used as the principal method of recruiting local capital in small amounts and increasing the lending capacity of local groups with significant loans from other sources, such as SBA, so that they can participate in substantial projects.

Local development companies raise their original capital from individuals and business concerns in the community or area by issuance of stocks, bonds, membership certificates, or notes or through solicited donations. The makeup of their corporation generally determines the most efficient method of raising capital. The type of corporation, and method of raising funds, depends upon local preference. Pledges may be sought from substantial local citizens and businesses, perhaps using installment or deferred payment plans over several years to collect the money. If the corporation has a limited membership, the capital may be raised from the members at the time of incorporation. SBA requires that the LDCs it assists have a minimum of 25 members. For corporations of this size it is considered more practical to solicit funds after the formal incorporations has been consummated.

FUNCTIONS OF AN LDC

Purchase and Development of Industrial Sites

More often than might be suspected, industries search in vain for industrial lands in areas where they would prefer to locate. Sometimes the available land is in parcels too small for their use. Often a suitable site is taken for another use, is not protected from encroachments, or is not provided with the basic facilities needed by industry. And, as often as not, when suitable land is found, the price is unrealistically high because of speculation.

The prime function of LDCs is the preservation and development of land for industry. A development corporation can option or purchase industrial land, partially or fully develop it, and hold it for sale or lease at a reasonable price. The basic steps in land development which can be performed in whole or in part by an LDC include –Preliminary Analysis, Acquisition, Planning, Land Improvement and Management/Marketing.

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*_The Local Development Corporation_, prepared by the Area Development Division, Bank of America and various other publications.

Supply Venture Capital to Industry

Local development corporations are also organized to make the type of secured loan a bank or other financial institution does not wish to make or is prohibited by law from making. A LDC can usually lend money for a longer period of time and for a higher percentage of the value of the property than banks and other capital sources.

Funds lent to industries new to the community are generally used to buy land and/or buildings. Funds lent to industries already established in the community are primarily used for the expansion of an existing plant, purchasing new plant equipment, refinancing, and supplementing working capital.

The LDC makes either direct loans or purchases stock in the aided firm. With a direct loan program, the repayments are usually made over a period of time, and the incoming funds can be used for re-investment more quickly than if they had to await the repurchase of the stock by the company. Under the stock purchase plan, the value of the stock which the development corporation holds increases in value as the business prospers, or vice versa.

Not surprisingly, the direct loan approach is preferred by most development corporations, and commonly involves taking a mortgage on the land, building or equipment. As safety measures, the LDC may limit the amount of funds that can be invested in any one firm and may limit loans to a maximum percentage of the paid-in capital of the assisted firm.

In those instances where the LDC uses its funds to furnish part of the financing for the construction or purchase of a building, conventional financial institutions may lend money on a mortgage basis to finance part or all of the remaining cost.

A 1959 Upjohn Institute report says that as LDC's "learn to foster only industry for which local resources are suitable and as they turn their attention more to fostering industrial growth from within, they may come to fill a permanent place in healthy communities by supplying loan capital to worthy new and existing firms which are unable to secure financing elsewhere. It is becoming apparent that such corporations may pay large community dividends, and may even become self-supporting."

Buildings

Many firms prefer to lease rather than to purchase or build plants for it requires no immediate outlay of funds, conserves borrowing power for other purposes, and makes rental payments chargeable against taxable income.

The local development corporation can often provide plant space on a rental or lease-purchase basis, either in new or existing vacant buildings. The speculative building, either shell (unfinished) or turn-key (ready for occupancy), is a useful device for some communities with a sound, experienced

LDC program under professional direction. It permits an industry to occupy a new building with a minimum of delay and interruption.

Counseling, Technical Advice and Other Services

The local development corporation–by furnishing members of its own staff, if it has one; by calling upon the experience of members of the corporation; or by hiring outside consultants–can assist a firm by:

- Providing much-needed management counseling or technical assistance.
- Working with other development groups for adequate community facilities and services, an equitable tax base, adequate zoning, and other evidence of a good business climate.
- Performing a liaison function between industry and government, utilities, labor, and other local groups.
- Conducting economic surveys of the community and area, and maintaining existing data.
- Making an inventory of all types of industrial land and buildings in the area.
- Helping local manufacturers market their products.

A division of these counseling and technical functions between the LDC and other development groups is desirable. Some of the services–economic surveys, maintaining economic data, and land and building inventory files–can best be begun or continued by other development groups, such as areawide planning and development agencies. Some of the services, such as the liaison function, can be cooperatively performed by both the LDC and the development district serving the area. Still others–working with specific industries seeking aid, management counseling, etc.–must be performed by the LDC alone, as must its unique functions of preserving industrial land and supplying risk capital to businesses.

This division of labor will minimize repetitive research, reduce costs to the development corporation, etc., and will maximize unity and cooperation between development-oriented groups in the community. For example, working with the industrial realtor, who is both a contributor to and beneficiary of the LDC programs, will result in professional assistance on land matters. Because of the "family relationship" between chambers of commerce, the development district and the LDC, the development corporation represents a new tool and a division and specialization of labor, not a separate force.

ORGANIZING THE LOCAL DEVELOPMENT CORPORATION

There are a number of decisions and steps involved in organizing the LDC.

Initial Leadership

In most communities the impetus for a local development corporation is provided by a single individual. The Federal Reserve Bank of Boston, which has devoted years of study to the LDC, notes that "successful organization and operation . . . requires at least one imaginative, progressive and energetic leader who can get things done." This leader will need the help of the areawide development agency staff and board and the local chamber of commerce or development association, the banker, the realtor who is interested in the community welfare, and other local leaders. These men will form an organizing committee to handle the details of the LDC policy determination, incorporation, etc.

Outline The Program For The Corporation

Decisions must be made at an early stage by the organizing committee regarding what area will be served; what portion of the program to stress (e.g. land purchase or supplying risk capital to industry); whether the LDC will be a part of the local chamber of commerce or other organization; whether it will have a profit or non-profit charter; how the corporation can be marketed to the community; etc.

The local development corporation idea can generally expect to meet with some initial opposition. An experienced community leader notes, "Perhaps one of the greatest problems to be solved . . . is gaining acceptance of the idea and need for a local development corporation. When we first attempted to promote our program, some of the influential leaders were less than lukewarm to invest in the corporation."

Two important questions to be decided are whether the corporation will be profit or non-profit and its relationship with other groups.

Profit or Non-Profit

Opinion is split as to whether the LDC should be profit or non-profit. Some maintain that the lure of profits will offer more incentive to invest in the corporation, while others argue that a community that really wants industry will be satisfied with the growth of payrolls and employment in the community. Conclusions generally cannot be drawn as to whether the profit or non-profit LDC is more efficient and/or has the higher ratio of benefits to costs.

A profit LDC is a "stock" corporation, primarily capitalized by the sale of ownership interests in the corporation. Because the stock sold is a capital asset, there is no chance of tax deductibility by the purchaser.

A non-profit LDC is a "membership" corporation, and capitalized solely by contributions. These are generally in the form of admission fees, dues, and assessments. Technically, the member does not have an ownership interest and is entitled to neither a share of profits nor any amount of capital upon dissolution of the corporation. This is the meaning of "non-profit;" it does not preclude profits accruing to the development corporation. Returns on investments, etc. go into a revolving capital fund during the life of the LDC. As a result, the contributions are generally deductible.

Tax deductibility is an important factor in the establishment of a non-profit corporation. It is important to have legal and tax advice on this and other aspects of organization. And, if the LDC, either profit or non-profit, wishes to borrow Small Business Administration funds it must satisfy the SBA requirement that the primary objectives be "benefit to the community as measured by increased employment, payroll, business volume and corresponding factors rather than monetary profits to its shareholders or members" which must be "merely incidental thereto." It is important that the organizing committee contact the SBA at an early date to be sure the LDC will meet other SBA requirements for loan eligibility.

Public Meetings

In the case of a profit LDC which will sell stock in the community or a non-profit LDC seeking community-wide contributions (many do not), a public meeting is essential to explain the corporation and its purposes to the community and to serve as the start of the public fund raising. Some pointers to keep in mind:

- As the meeting is meant to explain what the LDC would do, how it would do it, why it must do it, how it will be financed, etc., it is necessary to have developed the details of the corporation's program before the meeting.

- Make it clear that results, in the form of new factories, warehouses, etc., should not be expected within six months, a year, or five years. The business of encouraging industrial growth demands a long-run outlook, and much of the work of the LDC will not be evident on the surface. It is also necessarily confidential in many cases. An apparent lack of progress will lead to discontent and discouragement if the nature of the program is not understood.

- In those instances where community financial participation will be solicited, the public meeting becomes the start of the fund-raising drive. A public meeting to explain the LDC is even recommended in instances where the non-profit corporation is wholly financed by the business community.

- A professional industrial developer recommends that "the corporation first obtain 'private bellwether financial pledges' as seed money to talk about before any public meetings are held" and stresses that "local conventional financial sources must support the effort from the start, if only by quiet acquiescence."

Only after the LDC has been explained to the public, and the organizing committee has an indication of future financial support, should the formal organization be established. "You cannot emphasize greatly enough the fact that before they really organize in detail, they must have a commitment for the funds," writes one authority.

Legal Organization

When the initial steps outlined above have been taken, the organizing committee should begin the actual process of incorporation.

Incorporation is a relatively simple and inexpensive matter. But it is always necessary to have a qualified attorney draw up the articles of incorporation and other necessary documents in accordance with the corporation's plans and State law.

After the attorney has prepared the charter and it has been accepted by the incorporators, it will be necessary to adopt the by-laws and elect directors. The board of directors should represent all segments of the community, including local government, agriculture, and organized labor.

Control of the LDC will rest in its directors. Their range of activities will vary, depending upon whether or not an executive committee is appointed. The directors elect officers. The following is a possible organization: A Board of Directors of from 12 to 16; and Executive Committee of from 7 to 9; and four officers–a President, Vice-President, Secretary and Treasurer (who will be members of the Executive Committee).

This group, and any staff which might be utilized, will be responsible for the management of the LDC. Most small local development corporations do not have paid staffs or elaborate offices, relying instead upon services contributed by staff members of the local chamber of commerce, officers of the corporation, or local businessmen. One authority recommends that a professional industrial development man be secured, if only as a consultant on retainer, for "this is no simple task the community is putting its funds into."

The LDC is now ready for business. Its success, if not insured, will certainly be enhanced by adherence to some principles of success: leadership, capital, able management of funds, and a long-term, continuing program.

Understandably, a good deal of money will be required to carry out the programs of the local development corporation. The section which follows outlines how to acquire this capital, and the final section of the report is concerned with the management of the LDC.

SOURCES OF LOCAL DEVELOPMENT CORPORATION FUNDS

There are both private and public sources of capital available to the local development corporation. The private one to which the LDC will have the greatest recourse is capital obtained from contributions, in the case of a non-profit corporation, or the sale of stock, in the case of the profit corporation. The principal source of public funds will be loans from the Small Business Administration to the LDC and loans from various state industrial financing programs where they exist.

Private Sources of Financing

The source of community capital depends upon whether the LDC is profit or non-profit. A profit, or "stock," corporation gets its capital through the sale of stock to individuals or businesses in the community or area; a non-profit, or "membership," corporation gets its capital from contributions from individuals or businesses.

Non-Profit (Membership) Corporation

The capital is acquired through contributions–generally in the form of admission fees, dues and assessments–and the business community, supported by labor and service organizations, is generally expected to supply it. If this source proves inadequate, then there must be a broad citizen-supported base and/or a pledge system which permits businesses to spread out the contribution over a period of several years.

The following are some guidelines for soliciting contributions from the general public. Some of them also apply in cases where only the business community is being asked for contributions.

- The type of money raising should be suitable to the community. A check should be made of status and scheduling of other drives, e.g. church, community fund.

- Know the uses to which the funds are to be put (e.g. purchase and development of industrial land or lending money to industry). Prior unanimous agreement from the directors about these uses is essential for a successful fund-raising program. Have a clear-cut program for accomplishing these ends.

- Gauge the need for funds in advance. The collection of too little money may necessitate a second drive for funds, which is generally undesirable. It is better to have too much than too little. With a "pledge and call" system, the "call" can be deferred; the excess can go to other good uses or be put into a savings account until needed. What constitutes "adequate capital" is hard to answer and depends upon the program which is being undertaken. Generally, it ranges from $50,000-$500,000, with most having less than $100,000. Experts write that this latter estimate seems quite low, as a successful program is a continuing one.

- Determine who in the community will benefit the most from new industry and set goals reflecting these benefits. The Federal Reserve Bank of Boston notes that "far-sighted manufacturers" are often the largest investors in the development corporation, for they realize they share in the long-range benefits of operating in prosperous communities.

- Determine the method of payment. The principal ones are (1) contribution payable when the full amount is subscribed, (2) contribution payable on call, and (3) contribution payable periodically in agreed amounts. Many LDC's have no standing capital, using instead the "pledge and call" approach, generally conceded to be the best. However, some businesses will not wish to pledge on call more than a year ahead because of unknown business conditions.

- Have a pre-campaign public education program so that business, community, and public will understand what is being asked of it, why, and for how long. In instances where the citizens of the community or area are being asked to contribute, a professional fund-raising organization is often recommended. "most developers who used fund raisers have had their goals oversubscribed . . . and given the community a sense of participation which may aid local government in providing schools, sewers, and roads in the future," says an authority.

- When the fund-raising campaign is underway, use public meetings, mail campaigns, and personal solicitation to encourage contributions, covering the entire community or area to be served by the corporation.

- Contributions are tax deductible under certain conditions. This is, of course, a major selling point, along with asking people to buy "a share of the future" in their community. If the LDC is set up properly, the tax codes allow businesses to deduct contributions as a cost of doing business. The non-business contributor will probably not be allowed to deduct his contribution.

- In the long run, the LDC may develop assets considerably greater than its initial capital. These assets can represent investments in plants, suitable industrial sites, mortgages and loans, as well as operating cash. The gains are plowed back into the corporation for new projects.

Profit (Stock) Corporation

The points raised immediately above are generally valid for a profit LDC as well, but with some important differences:

- There is no tax deductibility as the stock represents a capital asset; profits or interest can be distributed to the stockholders, etc.

- While in the case of the non-profit "membership" corporation each member (contributor) generally casts one vote regardless of his contribution, in the profit corporation, the purchaser is generally entitled to cast one vote for each share held.

- By pricing the stock at popular prices, $25 and under, it will be possible to obtain broad ownership. But, while it is often desirable to have broad ownership, it is also desirable to centralize control in the directors or executive committee to speed decisions.

- Because of the nature of the LDC, the liquidity of the capital is almost nil.

Bonds of the Development Corporation–The issuance of bonds is possible as a source of borrowed capital, particularly for land purchases. An attorney should be consulted if bonds are to be considered.

Bank--There are no set guidelines for loans which banks can make to local development corporations, other than the general requirement that they be for a definite project, already well developed, and for a relatively short period of time. For example, it might be possible to obtain bank financing for the purchase of industrial land if it is clear that a major concern definitely plans to locate on that land.

A bank cannot lend for an indefinite period of time, so that bank financing to purchase land for long-range industrial land preservation and development is not likely. By the same token, banks generally can lend money for the construction of buildings only if there is a definite prospect who will use the facility, thus ruling out the financing of speculative shell buildings. But banks can participate with the Small Business Administration in SBA loan programs to small businesses and to local development corporations.

In any case where a LDC seeks bank loans, it should solicit the participation of all the banks within the community or area, rather than just one, and do so as early as possible.

Savings and Loan Associations–These associations, like banks, can make loans on the security of real property. It is possible in some instances that loans based on a higher percentage of the appraised value of the land and for longer periods of time would be available through savings and loan associations than through banks. However, like banks, it is unlikely that savings and loan associations can lend money for any long-run land purchase, development, and retention program.

Insurance Companies--As a rule, insurance companies are interested in lending money only on land located in recognized industrial areas and then only if the opportunities for building on the land look promising in the near future. An example would be an instance where an industry has decided on a specific site and the community for some reason would want to purchase that site.

Insurance companies generally do not lend directly to a LDC because of the uncertain earnings, its quasi-governmental status, and because the investment objective of the insurance company is a good long-term mortgage loan on excellent improved real estate with a good tenant.

Small Business Investment Company--In theory, long-term capital could be made available to a profit local development corporation from an SBIC. It is not likely, however, as the principal interest of the SBIC is to have part ownership in a growth industry rather than make loans.

Government Sources of Financing

Federal--Small Business Administration--The Small Business Administration (SBA) can be an important source of capital for the local development corporation. Through the SBA "502" loan program, the LDC borrows SBA funds which it either re-lends to a business or uses itself to acquire land, build a plant, expand facilities, or purchase equipment to be utilized by the specific industry. Without a LDC, this source of funds is not available.

State--Many LDC's receive considerable financial support though state industrial aid financing programs. Most of these state programs involve direct state loans to industry by state finance authorities. The loan funds are derived either from general fund appropriations or from state bond issues. The state authority participates with LDC's and conventional lenders in making long term loans to industry.

For example, under the Pennsylvania plan, the State Industrial Development Authority is authorized to make loans to nonprofit LDC's for part of the cost of constructing industrial plants. State participation can be as high as 40 percent of the total cost. The LDC must raise the rest of the funds from private sources of credit and through local subscription to the LDC.

The State of Oklahoma uses a variation of the Pennsylvania plan. A state development authority makes second mortgage loans to LDC's for industrial development projects. In this case, however, the state obtains its funds from state general obligation bonds instead of the state general fund.

Several states use a third alternative - the loan guarantee plan. Under this plan a nonprofit LDC forms the local base of the program. The LDC is financed solely through private sources, decides which projects will receive assistance and provides the approved projects with the necessary financing at a standard rate of interest. The state participates in this action by insuring the repayment of up to 90 percent of the loan. For this it receives a service charge of one quarter of one percent or more of the loan.

Local--There are several ways in which a municipality can offer assistance to the local development corporation:

- Provision of paved streets, installation of water and sewer lines, police protection to the industrial land, etc.

- Buy land and then lease or sell it. There is increasing attention being given to this method as a means of preserving industrial land. One possible way to finance this is through tax increment bonds issued pursuant to a resolution adopted by the local redevelopment agency, and pursuant to the Constitution and laws of the State. The city attorney can advise on this and other municipal land purchase possibilities.

- In some states it is possible for municipalities to purchase shares in the profit LDC. The community's status concerning the purchase of shares or contributions should be checked with the appropriate legal authorities.

The sources outlined above, private and public, are the principal sources of capital, either directly or indirectly, to the LDC. This does not mean the list is exhausted; local ingenuity can lead to the development of others. In any case, the consequences of any plan should be carefully considered before assuming financial obligations through the actual sale of stock or the calling of pledges.

These funds will be used for the LDC program already outlined–purchase and development of industrial sites, venture capital for industry, buildings, and counseling, technical and other services.

MANAGING A LOCAL DEVELOPMENT CORPORATION

Management means the provision of corporate accountability and control, and the proper direction of the enterprises.

The LDC has been created, the funds acquired, and the general direction of the effort determined. To assure that the goals are attained–through a long-term, continuing program–requires an apparatus of control and responsibility which will guarantee:

- Compliance with the laws–all applicable laws affecting the corporation, its holdings, right of stockholders, debtors, creditors, lessees, etc.

- A chain of command and responsibility–to guarantee responsible action by the development corporation.

- Communications–with stockholders, prospects, the community, etc., to supply progress reports, data, etc.

- Continuity–to assure the long range development of the program and realization of goals, operating policies will have to be established and utilized.

Policy and Prospect Evaluation

The LDC should establish both a loan policy and a checklist of evaluation factors to be applied to each prospect.

Loan policy could include provisions as to the type of industry to be assisted, loan limits, degree of flexibility of loans, etc. It is important to remember that the LDC is established to make loans that conventional sources cannot or will not make, and that loans should be flexible and oriented to the needs of the industry and the community.

The Committee for Economic Development (CED) in its publication, *Distressed Areas in a Growing Economy*, reports, "A number of community development corporations have made non-bankable loans to manufacturers. Interest rates on these loans were frequently similar to rates charged by conventional financial institutions. But community development corporations are likely to take lower grade collateral or none at all, to make loans for longer periods and to impose fewer restrictions than banks. Loan agreements with community development corporations are likely, however, to specify a minimum annual payroll or minimum employment."

Risk capital means what it says, but it does not preclude the thorough investigation of all industrial prospects, nor the denial of assistance to most of them. A checklist of prospect evaluation factors should be developed and used in investigating each firm seeking assistance. It should include investigation of the general reputation of the firm, length of time in business, quality of the management, and record of management continuity. The company's profit and loss history, present cash position, liabilities, etc., should also be investigated, as well as the company's product, its market, prospects for the future, etc.

The Federal Reserve Bank of Boston notes that one successful LDC has been operating for decades by: sponsoring diversified types of industry; providing liberal financial arrangements; arranging flexible repayment schedules adjusted to the client's ability to pay; maintaining close and personal relationship with the client concerns; and avoiding competition with existing lending institutions.

Adherence to the loan policy and a careful evaluation of each prospective industry will probably result in a high rejection rate. But a responsibility to the community must be fulfilled, as many of the applicants for LDC assistance will be bad product risks or "fly-by-nighters" looking for something for nothing. The local development corporation is not meant to be a "soft touch;" it is meant to supply risk capital, land, etc., to marginal but nonetheless responsible businesses--businesses which have potential tomorrow but not the balance sheet today to get conventional financing.

SUMMARY

A local development corporation is meant to promote jobs and income in the community by: (1) assisting existing industry in its expansion, (2) getting new local enterprises on their feet, and (3) helping new industry to establish facilities. It can do this by filling the needs of industry:

- Industry needs prepared industrial land at reasonable prices. A local development corporation can option or purchase industrial land, partially or fully develop it, and hold it for sale or lease at a reasonable, non-speculative price.

- Industry frequently needs sources of financing. The LDC supplies venture capital and opens ways to other capital sources. Funds may be made available for financing plant construction, acquisition of machinery, refinancing, etc., and for developing recreation-oriented industries.

- Industry often wants an existing building. The LDC can provide plant space on a rental or lease-purchase basis, either in new (often speculative) or existing buildings. As this can be an expensive program, it should probably be subsidiary to supplying land and venture capital.

- Industry often needs other services. The LDC–by providing members of its own staff (if it has one), by calling upon the experience of members of the corporation, or by hiring outside consultants–can, in cooperation with the chamber of commerce or other development groups, assist industry by providing management counseling, working for adequate community facilities, performing liaison functions, conducting economic surveys, making industrial land inventories, helping local manufacturers market their products, etc.

The LDC is initially and necessarily financed with private funds secured from contributions, in the case of a nonprofit corporation, or through the sale of stock if a profit corporation. It may supplement this capital by borrowing through loans or the sale of bonds, and by utilizing federal loan programs such as those of the Small Business Administration and the Area Redevelopment Administration.

A soundly-conceived community-supported local development corporation led by dedicated and well-indoctrinated individuals is an asset to any community or area. This report outlines the major considerations for such a program. More detail on each step is available from a wide variety of sources, some of them mentioned in the text.

SOURCES OF ADDITIONAL INFORMATION

American Industrial Development Council, Room 717, 230 Boylston Street, Boston, Massachusetts

Bank of America, Area Development Section, San Francisco, California 94120

Industrial Development Guide, 1962
Land for Industry, 1964
How to Get Community Action, 1964
Sources of Capital and Credit, 1964
Uncovering Weakness in Manufacturing Organization, 1961

Federal Reserve Bank of Boston, Boston, Massachusetts

Small Business Administration.

University of Tulsa, College of Business Administration, 600 South College Street, Tulsa, Oklahoma.

COMMUNITY DEVELOPMENT CORPORATIONS

A community development corporation (CDC) is essentially a cooperative, set up in an area to run economic and social service programs for the community. CDCs' main activity at this time is operating business or profit-making ventures for the community. Some have set up factories or shopping centers, and others run maintenance services, gasoline stations, or stores. Other CDC's operate local services, as well as perform municipal services under contract from local government. A CDC can be set up by civic groups and churches or by any group of individual residents of an area. Once it is established by law, it has the legal rights of any corporation, including the right of limited liability. Depending on the manner in which it is set up, and on its activities, a CDC may or may not be exempt from some taxes.

A CDC may see its functions as purely economic, that is, building the area's economic base, increasing residents' income and improving job opportunities, or, more narrowly, as providing some specific and concrete services, such as day care centers or schools. Some CDC's may also be concerned with political action.

A CDC really merits its title if any community member may join. For a CDC really to represent the community, it should be based on a principle of full community participation in decisions. In principle, this inclusiveness distinguishes the CDC from ordinary private businesses, such as those usually mentioned in programs for minority business enterprise, as well as from branches of large corporations in economically distressed areas. In these ordinary private businesses, a limited group of individual owners or partners or shareholders run the corporation, and receive the profits for their own private use. In a CDC, the profits, if any, accrue to the community, and the community decides what to do with them. CDCs, thus, are a possible, form of organization for an area that has economic social, or political needs, and is interested in working out new ways for the members of the community to cooperate with each other in meeting them.

Functions of a CDC

A CDC seems most appropriate for areas interested in all aspects of community development--areas which realize the necessity for establishing locally controlled economic institutions which will eventually be able to support other forms of development, such as education, health, and job training. Thus, a key element of any CDC will be the creation of income-producing entities owned and controlled by the community. Although CDCs almost always aid individual businesses in an attempt to develop all of the area's economic resources, the main thrust will be on community ownership so that profits can be used in ways the community feels are most important (from day care and job training to payment of cash dividends or shopping discounts).

There is no one kind of business enterprise that is most suitable for a CDC, and almost everything has been tried–electronic factories, grocery and other retail stores, catfish farming, production of modular housing units, real estate development, low-income housing, janitorial services, and franchises.

When local services, such as job training or community schools, are run by existing poverty programs dependent on Federal or State government approval for each and every project, it can severely limit the power of the communities involved to act for themselves. Therefore, one argument for setting up a CDC with some profit-making branches is that these profits can be funneled into a community fund which could, in turn, pay for those services the Federal or State government will not support, increasing thereby the community organization's freedom to act. Moreover, if a community organization can establish a successful community business, experience shows it might have other beneficial results.

A CDC can be a source of pride and community solidarity. It may be owned by anyone in the area who buys a share for some low price, or who earns a share through volunteer work for the corporation, such as helping build community facilities or even selling shares. Furthermore, the CDC may operate, as cooperatives do, on a one-man, one-vote basis, to pick its board of directors. While the corporation can let people buy more shares, and pay dividends (interest) on them when profits are made, it cannot allow the organization to be run on a one-share, one-vote basis without risking the whole corporation ending up as the private business of a few large stockholders. The board of the CDC must be elected under the one-member, one-vote system. Sometimes, however, a CDC might start out with a board already constituted, representing a coalition of existing community organizations (or the board members of an area development district) and work for a couple of years to become established before holding elections (part of a spinning-off process from a district). But in the end, the more people it involves in the control of its activities, the more the CDC can build or deepen community spirit.

The business enterprises of the CDC can provide jobs for people who are normally kept out of the job market. They can do so by hiring people from the area with less rigid rules (such as hiring people with police records) than private businesses might have. They also can receive government job-training funds, or train people themselves, so that the people they hire do not all have to begin with previous training and experience. The CDC's jobs may also be a vehicle to economic mobility for area residents. People trained by their work in the CDC may move to new jobs with private companies, or to running their own businesses, or to new positions of community service, as a result of this experience.

A community corporation can attract more funds for community services. Based on past experience, a community organization seems to raise more private contributions for its activities when it shows it is doing something constructive to make some of its own money.

Organizational Structures: Non Profit, For Profit, or Cooperative

There are essentially three basic structures for CDCs. They may be for-profit corporations, nonprofit corporations, or cooperative corporations. The structure of existing CDCs vary considerably, but a structure consisting of a nonprofit CDC with for-profit subsidiaries for each business that entered into is more popular than other formats. This structure satisfies a number of needs. The nonprofit CDC is a potential recipient of charitable grants and carries out any social program that the subsidiary's profits make possible. It can channel the grant money into the businesses by using the money to purchase the stock of the subsidiary corporations.

The profit-making subsidiaries carry on business operations and they are taxed on profits, but the dividends remitted to the parent corporation are not taxable. Each business is separately incorporated in order to shield a profitable business from a disastrous bankruptcy in a second enterprise. Also, one subsidiary might be an SBIC or other entity requiring special by laws. For tax purposes, a common variation is to insert a holding company between the parent and the subsidiaries. This structure allows the subsidiaries to pool their profits and losses when filing a Federal tax return, which has obvious advantages if one company is earning profits while another is losing money. However, only subsidiaries of a profit-making corporation can file such consolidated returns.

Besides wholly-owned subsidiaries the parent can have part ownership in some entities. This kind of partial ownership may in fact be required to take advantage of certain opportunities. For example, SBA requires 51 percent ownership by minority individuals before it will allow a corporation to take part in its lucrative 8(A) set-aside program. Further, at some point the CDC may wish to allow direct community stock ownership of one or more of its successful businesses, and it will be easier to spin-off a separately incorporated business.

In this structure, community control centers at the top with control of the nonprofit CDC. The CDC's charter will set out the rules for membership. One possibility is to allow an area resident (in a defined geographical area) to join. An income limitation also could be imposed. Another possibility is to restrict membership to representatives of existing community groups. If these groups represented the varying interests of all of the area, there would also be effective community control.

If a profit-making corporate structure is chosen for the CDC, its stock could be owned by the residents of the area. However, for many reasons (one major reason being the Federal securities laws and a second being the poor psychological effect of selling stock in a risky or failing business) profit-making corporations do not ordinarily begin by selling stock to the community. In this case the stock may be held temporarily by a nonprofit group. Another possibility is to have the stock held by a trust set up for the benefit of the area. The trust decides when and how to spend profits and when to sell stock to the community at large. The trust might never sell all of the stock so that some stock will remain in the trust for the benefit of the area as a whole (including those members of the community who either could not afford to purchase stock or did not recognize the stock as a good buy).

In any given area, many interacting and sometimes opposing factors will need to be examined before deciding upon a corporate form. These include, among many others: (1) the possible sources of funding; (2) the kind of business to be entered into; (3) the psychology of the community; (4) the desired method of injecting community control and participation and for returning benefits to the community; and (5) Federal tax considerations.

For example, in order to receive foundation contributions there must be a non-profit corporation with a Federal tax exemption. On the other hand, certain SBA monies are available only to profit-making entities. If the community plans to market home-grown or homemade objects and share the profits according to each individual's output, then a cooperative corporation may be the best answer, although in many States cooperative corporations are by law required to be too limited in scope to function well as a CDC, which should be a multipurpose corporation. In some states a cooperative corporation could act as the umbrella organization. However, it may be more appropriate to have a for-profit or non-profit corporation as the umbrella organization which would in turn encourage the community to organize a cooperative for those economic activities for which a cooperative is appropriate.

Some poor communities distrust any profit-making entity, having experienced corporate exploitation for too long, and they will grant their trust only to a non-profit organization. On the other hand, there are some poor communities who have been totally disillusioned with the efforts of existing non-profit service groups, and they will respond positively to a profit-making format where they can get a piece of the action. In some other communities these two tendencies exist concurrently and then other factors may exert more influence in the ultimate decision. If the umbrella organization is a non-profit corporation, then community control cannot be in the form of stock ownership, and control is achieved by membership in the corporation. The difference is that benefits cannot be passed to the community by paying dividends to the stockholders. In fact, members in a non-profit corporation can obtain no benefits in their role as members (as residents of the area they may, of course, benefit from the CDC's operations). This should not discourage use of a non-profit umbrella corporation, however, since, in general, corporate dividends are a poor way to funnel benefits to a community. But, a community may feel strongly that dividends are desirable.

If a business is carried on within a tax-exempt corporation and it can be shown that the business furthers the exempt purposes of the organization, then any profits of the business will be available tax-free for other community purposes.

A CDC has to discover some product or service that has a market for which it can produce, and to whom it can sell. It might also have to employ technical expertise in setting up specific industries or projects, without handing over control of its enterprise to outside experts. And it has to raise capital without giving up community control of the voting stock. Where government agencies are involved, funds are sometimes available for the initial studies of projects. In addition, various corporations, under pressure to do something for the poor, can be a source of funds. With some initial capital raised either from such sources or in the area itself, the CDC can qualify for loans from either SBA or private banks. Of course, the more capital raised as grants or as investment by area residents, the less control the CDC will have to give up, and the smaller the debt burden facing it.

Contributions and Tax Exemptions

Capital is becoming increasingly difficult to raise as corporations and government agencies begin to feel relieved of their social obligations after their first few contributions or as the experience of community control intimidates them. But some sources still can be found.

Many community-based development corporations have sought and received private grants and contributions, partly because of anticipated difficulties in marketing stock in an untried venture to residents of the area or outside investors and partly because contributions are a source of capital which neither requires repayment nor gives the contributor an ownership interest. To acquire substantial private contributions, a CDC must normally qualify as a charitable or educational organization under Section 170 of the Internal Revenue Code, entitling its individual and corporate donors to deduct the value of their gifts. A contributor can choose among many organizations anxious to receive his donation, and prefers to donate when the tax laws reduce his actual expenditure. Even tax-exempt foundations make almost all of their grants to Section 170 organizations.

To be eligible for tax-deductible contributions a CDC must be organized and operated "exclusively for . . . charitable . . . or educational purposes," per subsection 170 (c) (2) (B). "Exclusively" has been interpreted to mean "primarily", as IRS regulations permit "insubstantial" nonexempt purposes. Further, no part of net earnings may inure to the benefit of persons with a private interest; thus such a CDC cannot attract capital by both soliciting deductible contributions and issuing dividend-bearing securities. Finally, such a CDC may not substantially engage in attempts to influence legislation or play any role inpolitical campaigns–a condition some organizations–may find unattractive. A CDC meeting these three requirements will enjoy the further advantage of tax exemption on various forms of passive income (dividends, interest, annuities, and fixed real estate rents excluded from unrelated business taxable income) and on income from business activities which are related (aside from the need for funding) to its charitable or educational purposes (taxation of income of an exempt organization's unrelated trade or business). The operation of an unrelated business, though its income is taxable, will not destroy the deductibility of contributions so long as it does not negate the primacy of charitable or educational purposes. Until the CDC turns a profit, contribution deductibility is far more important than income exemption.

The most troublesome qualification requirement for a community economic development corporation is that its sponsorship of area business be deemed "charitable" or "educational." The regulations define "charity", in part, as activities for the relief of poor or underprivileged persons, or for the promotion of social welfare by lessening tensions, eliminating prejudice and discrimination, or combating community deterioration. "Education" includes the training of individuals to improve their capabilities. [Sections 1.50(c)(3)-1 (d)(2) and 1.50 (c)(3)-1 (d)(3)(a).] While job skill training is a major goal of many CDCs that purpose alone will rarely justify the scope of planned business operations. Thus, the existence of a "charitable" purpose will be the central problem in determining the deductibility of contributions. Aside from the general definition above, authority on that question is relatively sparse.

Some support for granting Section 170 status can be gathered from the treatment of non-profit social welfare organizations which assist ghetto businesses Section 501(c)(4). A public ruling has granted tax exemption to non-profit organizations which make soft loans to induce outside businesses to locate in depressed areas and thereby reduce unemployment. Assistance in the form of grants or limited equity investments rather than soft loans should not affect charitable purpose; neither should the fact that indigenous rather than outside businesses are aided. In fact a 1969 Senate report indicated that investments in small inner-city businesses were considered to be a charitable activity. A series of private rulings has also made such extensions. One of the more far-reaching rulings allows an economic development corporation, supported by the financial and business communities, to make soft loans and equity investments, if the assisted business is unable to obtain conventional financing and is controlled and primarily owned by minority group persons residing in disadvantaged areas.

HOUSING DEVELOPMENT ORGANIZATIONS

INTRODUCTION

Recently, the regional (areawide) or multi-county approach to housing development has received increasing emphasis as one of the best ways to solve local housing problems in nonmetropolitan areas. The prime justification for an areawide approach to housing development is that it provides a more effective technique to overcome problems of costs vs. scale of operations of uncoordinated local programs, lack of personnel, and lack of information.

Additionally, an areawide approach to housing development is a compatible with the movement in most states toward a statewide system of substate planning and development organizations. These multi-county agencies can play a key role in organizing areawide housing commissions as independent organizations to function as a catalyst to extend local housing efforts where they exist or undertake local action where there is none at present. Once an areawide housing commission has been organized, the areawide planning and development district can provide management and technical assistance to the housing agency, coordinate areawide housing activities with other related areawide plans such as land use, water and sewer, and industrial development, and provide a link with general and special-purpose local governments.

PURPOSES AND OBJECTIVES

The primary target of an areawide housing commission is to increase the quantity, quality and distribution of reasonably priced housing throughout the area. Accomplishment of this goal involves:

- A workable plan of housing delivery to low-and moderate-income families, making use of all available types of local, State, and Federal housing programs.

- An increased level of cooperation and coordination within the local counties and communities so that all relevant bodies and agencies become actively involved in housing.

- Better exchange of human talent in the housing field between the area's counties and communities.

- Better management and utilization of the area's private and public housing stock in order to provide a greater range of housing choice to meet the needs of families with limited incomes.

- Greater dispersal of information to buyers, builders, and sponsors about housing alternatives and development programs that are appropriate to development of economical housing in the area.

To achieve these goals, an administrative structure is needed that is large enough to deliver housing services at a scale that can have a significant impact on housing problems. The areawide housing commission is simply a practical tool for coordinating diverse elements of a complex program of operations on a scale compatible to the size of the problem.

A key factor is both organizing and operating an areawide housing commission is the degree to which local governments and citizens are committed to its success. The real test of local commitment will arise as procedural decisions are made about the commission's legal jurisdiction, membership, and programs. In this connection, three types of local commitment must be forthcoming:

- Jurisdictional-local governing bodies must recognize and give jurisdiction to the Commission.
- Membership-local governing bodies and existing local housing authorities must exert an active influence on the Commission and its operations, and
- Financial-local revenues must be pooled, as necessary, to support regional actions in solution of local problems.

LEGAL CONSIDERATIONS

Another important consideration in determining the feasibility of an areawide housing commission is the legal ability for it to become an operating entity. This depends primarily on state enabling legislation, which varies considerably regarding the establishment of areawide housing commissions. A rather typical situation exists in Kentucky where state statutes set forth the basic elements and procedural requirements for organization. These basic prodecures can be summarized as follows:

- An areawide housing commission can be created by the simple act of having each of two or more contiguous counties adopt a resolution declaring there is a need for one housing commission to be created for all such counties. However, no such Resolution can be adopted in any County where there is an existing county housing commission unless all holders of any outstanding bonds or evidences of indebtedness of such county housing commission shall consent in writing to the creation of a areawide housing commission, and the county housing commission must adopt a Resolution not to thereafter initiate any projects within such county.
- No areawide housing commission can undertake any housing project within the boundaries of a city unless a resolution has been adopted by the governing body of the city and any city housing commission declaring that there is a need for an areawide housing commission to exercise its powers within that city. Within this limitation, however, an areawide housing commission has the right to exercise all of its powers within all of the counties for which it was created.
- The areawide housing commission may increase its area of operations to include additional contiguous counties through similar procedures.
- Before any areawide housing commission can be created, the governing body of the city and county must adopt a resolution declaring that there is a need for an areawide housing commission and that housing conditions in the area are inadequate.

PROCEDURAL STEPS

The Kentucky state law requires a series of basic legal steps to be followed in the incorporation of an areawide housing commission. These procedures include resolution by the appropriate municipal governing body, public hearings, a second resolution, adoption of organization bylaws and an election of corporate officers. Each county appoints one member of the commission. The commission constitutes a public body corporate, having all necessary powers to prepare, acquire, complete and operate housing projects, to enter into contracts and leases, and to issue bonds payable from the income and revenue of housing projects, financed with the proceeds of such bonds.

In effect, the basic requirements for an areawide housing commission are similar to any independently operational corporate body, i.e. articles of incorporation, bylaws, board of directors, executive director and technical staff. The only significant differences between a housing commission and any other corporation are contained in the formation and operational limits surrounding the commission as a public body. There are specific procedures to be followed in appointing members and gaining jurisdictional powers for an areawide housing commission that do not apply to private corporations. However, in most other respects, the structural requirements are similar - legal incorporation, functional organization, and administrative management.

In organizing an areawide housing commission a major problem often involves the incorporation of the existing local housing authorities into the areawide commission. A local housing authority wishing to become a part of the areawide commission can declare itself inoperative and transfer its property and jurisdiction to a new organization. This requires passage by the LHA board of directors and agreement by all holders of bonds and other debt instruments that they are willing to transfer their claim to the new commission. This procedure is often impractical because of difficulties in getting all creditors to agree. If it is impossible for a local authority to be dissolved, it can contract with the areawide commission for management and operational services. In this way the commission is able to have areawide coverage without complete ownership of all existing units.

The organizational structure of the areawide housing commission is the sole responsibility of the organization's elected officers. To deal with the problem of inadequate or insufficient low-cost housing, most areawide commission will need to create a development-oriented arm within the commission to develop and coordinate new approaches to solving housing problems and increasing the delivery of all types of low and moderate income housing in the area.

Management services for existing and new public and low-rent housing should also be considered in the establishment of an organizational structure for the housing commission. Either by contractural agreement with existing local authorities, or by some other arrangement, the areawide commission should have responsibility for improving the quality and efficiency of management of low-rent housing. Therefore, it may be advantageous for the commission to develop its own managing agency and to cooperate with developers of new low-rent housing in sponsoring their projects.

RESPONSIBILITIES

Once formed, the areawide housing commission will be wholly responsible for the development and operation of low-rent public housing units within the jurisdictions of its member counties and cities.

Its primary purpose will be to improve the quantity, quality and distribution of public housing units in order to better serve the area's low- and moderate-income families. Thus, for the area it serves, the commission will have three basic responsibilities:

- Development
- Management
- Coordination

The principal development responsibility of the commission will be in the construction of new, additional low-rent public housing units. One of the first decisions any new areawide commission is going to have to make concerns what types of public housing programs it will use. Conventional public housing is in great demand all over the nation, while local housing authorities are encountering increasing difficulty in getting conventional public housing funded through HUD and no new commitments are being made under the low-rent public housing program. There are other alternatives, however. The turnkey programs and leased housing programs are examples. Under the turnkey programs, housing commissions can develop public housing which is intended for eventual ownership by its occupants. Under the leased housing programs, housing commissions may acquire privately owned dwellings for the purpose of renting to low-income families at rents they can afford.

Normally, housing authority-owned dwellings have been permanently financed at or near completion through the sale of long-term bonds to the public. These are usually forty-year serial bonds secured by the Federal government's pledge to pay annual contributions in sufficient amounts to meet principal and interest payments. In 1972 such bonds sold at an average interest rate of 5.1 percent. In addition, Federal loans have been made to authorities to finance the early costs of project development, modernization of existing projects and certain administrative requirements, and Federal operating subsidies have compensated them for the cost of mandatory rent reductions imposed by Federal legislation.

Above all, the commission must be flexible in its choice of ways to increase the supply of low-rent housing in the area. One of the major problems with existing local housing authoritatives is their characteristic dependence on a single public housing program. The areawide commission will have to adopt a broader perspective and use whatever programs feasible to increase the delivery of low-cost housing.

A related responsibility of an areawide commission concerns other housing besides public housing. The board and staff of the commission should be directly responsible for the initiation of other low- and moderate-income housing programs. While the commission may not be the sponsor, it should do everything in its power to promote further housing development by other private or public sponsors. A major responsibility of the commission should be to provide technical assistance, information and advice to any organization, group or individual interested in building low- and moderate-income housing.

The management responsibilities of the housing commission are broader in scope than its development responsibilities. Naturally, the commission will be responsible for the management of any additional public housing units it constructs, although it can contract to have them managed by another group if it so desires (Turnkey II). But beyond the management of new units, the areawide commission may serve as the management for other existing public housing through a contractual or cooperative arrangement with existing local housing authorities that are not members of the commission. Thus, there are really three management responsibilities for the areawide commission:

- Management of its own new public housing units;
- Management of public housing units it gains through local housing authority membership; and
- Management of existing independent local housing authorities' units on a contractual or cooperative basis.

Beyond public housing, the commission can manage other types of low-rent housing through contractual agreements with their sponsors. Many would-be sponsors lack the experience or capability to manage low-rent housing and would be more able to develop new housing if a dependable management agent could be secured. Similarly, the commission can benefit from the management revenues it receives and the expanded opportunity to develop additional low-income housing.

RECENT DEVELOPMENTS IN AREAWIDE HOUSING

Recently, several states and nonmetropolitan planning and development agencies have initiated areawide housing programs. In Georgia, four APDCs are undertaking an 18 month regional housing program to upgrade housing conditions and at the same time provide jobs through industrial development. The Councils will provide technical assistance to local profit and nonprofit housing corporations, including financial, paper work, development of housing site plans, and coordination of mortgage commitments.

The Middle Flint APDC in Ellaville, Georgia has set up a Middle Flint Area Development Corporation with the same board of directors as the APDC. This has the effect of linking the APDC's planning with the implementation responsibilities of the Development Corporation. Under the program, the Development Corporation purchases homes which are run down but basically sound. It rehabilitates the houses for resale to families of low and moderate income. With federal mortgage guarantees, buyers have been afforded interest rates ranging from one to three percent depending upon their income.

Also in Georgia, the Coastal APDC has served as a catalyst for the formation of a Regional Housing Authority covering seven counties. The Authority plans to address its activities to low and moderate income housing for lease and purchase and develop some activity for producing housing for the elderly. The executive director of the APDC also serves as director of the new housing authority.

In Texas, 24 areawide planning councils are in the process of establishing regional housing data banks to ascertain housing conditions throughout the state. This project is being conducted in conjunction with the Housing Division of the Texas Department of Community Affairs.

In recent years, several states have become involved in the delivery of low and moderate income housing in rural areas through the creation of state housing agencies which help develop viable nonprofit housing delivery systems in rural areas. Several states are noted for the activity of their state housing corporations. Michigan and North Carolina have developed innovative state housing programs. More recently, Oregon's Department of Commerce has been working with the state's regional councils to identify and solve housing problems. In 1972, several states including Georgia, Virginia and Kentucky, passed legislation creating state housing development corporations or authorities.

SOURCES OF FINANCING

The recent freeze on most federal housing programs will present a severe constraint on the development of low and moderate income housing in rural areas and on the activities of local and areawide housing agencies operating in nonmetropolitan areas. In addition, the freeze is expected to discourage the establishment of new local and areawide housing corporations.

The 18 month suspension of Farmers Home Administration (FHA) rural housing programs will be particularly detrimental to rural housing development. Since FHA actually loaned money for the construction of housing in rural areas rather than insuring mortgages, the freeze on most FHA programs means that a major source of funds for rural housing development have been at least temporarily eliminated.

Rural housing programs effected by the freeze include:

- Homeownership (Section 502) loans to low-income families that involve an interest creditor subsidy. Subsidized interest rates to borrowers have ranged as low as one percent under the present program.

- Rural rental and cooperative housing loans (Sections 515 and 521).

- Farm labor housing program of grants plus loans at one percent interest. The new budget proposals also include $1,84 billion for moderate income housing loans and $44 million for rural rental housing loans.

Although these programs have been temporarily halted, FHA has announced the continuation of housing repair (Section 504) loans (maximum $3,500 per family), rural homesite loans, nonsubsidized 502 loans at 7-1/4 percent interest and the reopening of its nonsubsidized rental housing loan program. Of the subsidized housing programs, only self-help housing technical assistance grants and site loans were left intact. With these programs still partially intact, some construction will continue throughout 1974.

Even with the freeze on federal housing programs, rural housing agencies still have an important role to play. It now becomes essential that these agencies explore ways of tapping resources available through the private mortgage and real estate industry, and working with state and local governments to increase their financial committment to housing construction.

HOUSING PRODUCTION ORGANIZATION–A PROPOSAL

Nonprofit agencies are an alternative to the traditional local housing authority structure. For example, the Oklahoma legislature has authorized rural electric cooperatives to establish local housing authorities for their services areas, and at least four coops have taken advantage of the law to get involved in Turnkey and leasing programs for public housing. As exemplified below, the rural electric, or similar coops may provide the organizational solution to the low and moderate income rural housing production problem.

Requirements for Rural Housing Development Organization Operation

- Financable
- Tax-paying
- Consumer-endorsed
- Nonprofit sponsored
- Resalable shelters
- Self-help Involvement
- Employment Generation

The best vehicle in this case may be a broad-based, cooperatively-owned utility corporation empowered to sell tax-exempt revenue bonds providing for a lease-purchase arrangement between the cooperative and the cooperative member-homeowner with some Federal and/or State subsidy. The initial equity to insure the sale of the tax-exempt revenue bonds might be developed through investor faith in the credit of the Federal and/or State governments (similar to rural electric cooperatives). Federal and/or State guarantees and member finances provide the collateral the lender needs for a safe loan. Tax exemption and tax shelter of its indebtedness encourages reduced interest rates. The participation of the cooperative members provides for employment and self-help. The units constructed are guaranteed resalable because the cooperative retains first ownership. The cooperative's assets can produce taxes to local governments, although these may be reduced by agreement with local governments (as a cooperation agreement with local housing authorities). Federal and/or State guarantees of a percentage of repayment could have two to one leverage on the number of units produced. The cooperative member could lease from the cooperative based on a percentage of income and could acquire equity by any additional investment deposited against the obligation of the unit he occupies. The shelter provided could be single-family, multi-family, or condominium.

LIMITED–DIVIDEND APPROACH TO HOUSING

Under current Federal and State tax regulations, substantial tax advantages are granted to profit-motivated developers or owners of real estate. These tax advantages or tax incentives provide for profits independent of development and operating costs borne by the tenants. In effect, by foregoing taxes which it would otherwise collect, the government pays these profits. The tax treatment of a project constitutes an important indirect subsidy to housing. These incentives take the form of tax deductions created by construction expenses and depreciation allowances. Such deductions result in losses for tax purposes during the early years of a project's operation, and these losses result in tax savings when applied against taxable income from other sources. Since the tax losses protect income from taxation, these incentives are referred to as tax shelters.

Although losses are reported for tax purposes, the project actually should realize a positive cash flow. After all expenses and mortgage payments are accounted for, there should be a surplus remaining from rents collected. The reason for this difference between the tax and cash accounting is that depreciation allowances create a loss without representing a real expense to the project. The distributable cash flow is limited to six percent of the original equity required. This cash distribution can be taken out tax free until the tax losses for the project run out. These tax incentives are often of such magnitude that the limited dividend sponsor cannot use all of the benefit directly. And, since there is a need to raise capital for equity requirements, the tax losses are usually sold to investors in high tax brackets.

The usual vehicle for investment is a limited partnership, with the sponsor retaining an interest as general partner and selling the remaining interests to limited partners. The tax losses can be used to offset the personal income of the investors, resulting in tax savings, and the investors receive a share of the cash flow generated by the project. The organization of such a limited partnership and the sale of such tax and cash benefits is referred to as syndication. The net syndication value of a new apartment development varies from eight to fifteen percent of the mortgage.

COOPERATIVES

INTRODUCTION

Cooperatives are voluntary business organizations formed by groups of people with similar needs, such as electric power, credit services and consumer food purchasing, marketing products and buying supplies. Cooperative corporations are a special kind of corporation, with the same advantages as ordinary corporations over individual and partnership firms. Incorporated cooperatives can continue doing business during a change of ownership, and the owners' liability for debts of the firm usually is limited to the amount of money that they have invested. Cooperative corporations get their corporate charters under State laws designed specifically for cooperatives or under nonprofit corporation laws. If a cooperative elects not to incorporate, it has a legal status somewhat similar to a partnership.

All cooperatives have three fundamental characteristics in common. The first is democratic, member or member-patron control - control by people using the cooperative. Cooperative members in most instances have one vote irrespective of capital invested or volume of patronage. In some cooperatives, however, members vote according to their volume of business with the cooperative. Voting to elect a board of directors gives members a voice in controlling their own business, while the directors decide policy and employ a manager or chief executive (and perhaps other key staff members).

The second characteristic stresses operating at cost. Any excess of revenue over expenses (net margin) at the close of the fiscal year is divided (actually returned or only allocated on the books) among member-patrons in proportion to the amount of their business transactions with the cooperative. As a rule, at least twenty percent of patronage refunds must be returned to the patrons in cash, while the remaining portions may be credited to them but retained by the cooperative to provide additional capital. The directors decide how the distribution of refunds is completed, when it is distributed, and the form of the distribution. Finally, the cooperative pays a limited rate of interest return on member-invested capital. Members generally may receive interest type payments limited to eight percent of less, only for the use of the money capital that they invested in their cooperative. Thus, the cooperative may pay interest on member investments as one of the costs of doing business. Restrictions on investment returns discourage attempts to take advantage or control of cooperatives for personal gain. Many cooperatives pay no interest on member capital.

There are many kinds of cooperatives. Farmers own coops to market their crops and livestock products and to get credit, supplies and services. Consumers own coops to get housing, credit, health services, food, electricity, telephone service, dignified burial or insurance. They include parent-owned nursery schools, neighborhood-owned recreation centers and swimming pools, business-owned central food and hardware buying organizations, and handicraft producer-owned supply and marketing organizations. A coop may have only one function, or it may have many functions. Similarly, it may serve a relatively small community, or people in several states. Coops often own other coops, however, Federal and state laws (which vary in detail from state to state) may limit coop operations (monopoly laws, etc.).

FINANCING

In addition to member investment (risk or venture capital), cooperatives may obtain loans from commercial banks and other lending organization's, individuals, and government sources. The Federally-established Banks for Cooperatives assist in meeting the specialized credit needs of some 3,000 farmers' marketing, supply and farm business service cooperatives. Certain types of technical services are also provided the cooperative borrowers. Eligibility to borrow from these banks is restricted to cooperative's in which ninety percent of the voting media is held by farmers. Rural electric and telephone cooperatives can obtain capital not only from private sector financial institutions, but also from the National Rural Utilities Cooperative Finance Corporation, the Rural Telephone Bank, and the Rural Development Insurance Fund (guaranteed and insured loans from the Farmers Home Administration). Depending upon pending congressional and executive actions, rural electric and telephone cooperatives may or may not be able to avail themselves of the long-term, low-interest direct loan assistance traditionally provided by the Rural Electrification Administration, which continues to provide management and technical assistance. Information is available from the National Rural Electric Cooperative Association and the National Telephone Cooperative Association.

Federal credit unions are privately owned, cooperative associations organized for the purpose of promoting thrift among their members and creating a source of credit for provident or productive purposes. The National Credit Union Administration charters new Federal credit unions, supervising established Federal credit unions, making periodic examinations of their financial condition and operating practices, and providing insurance through the Credit Union Share Insurance Fund for member accounts in Federal credit unions and State-chartered credit unions which apply and qualify. The National Credit Union Administration will provide information upon request, as will CUNA (Credit Union National Association) International.

Nonprofit housing cooperatives may qualify for mortgage insurance and supplemental loan insurance under the Department of Housing and Urban Developments' Section 213 programs. Assistance is available for the purchase by cooperative members of nonprofit coop sponsored housing and purchases of multifamily housing by coops. Information on cooperatives for housing can be obtained from the Special Assistant for Cooperative Housing, Housing Production Mortgage Credit/FHA, in HUD, and from the National Association of Housing Cooperatives, the Foundation for Cooperative Housing, and the Farmers Home Administration (USDA).

The Farmer Cooperative Service (FCS) is the U.S. Department of Agriculture's specialized agency in cooperative organization, operation, and development. FCS helps rural people take the necessary steps to organize cooperatives, usually with and through other Federal and State agencies, and helps existing cooperatives in their operations. County agricultural extension agents and Farmers Home Administration county and state offices have information on rural cooperatives and can make referals to co-op specialists at the State land-grant universities. U.S.D.A.'s Rural Electrification Administration can supply information on rural electric or telephone cooperatives. The Cooperative Bank Service of the Farm Credit Administration and the thirteen district banks for cooperatives have information on financing farmer cooperatives, as does the National Council of Farmer Cooperatives.

The Chief, Division of Current Economic Analysis, National Marine Fisheries Services, National Oceanic and Atmospheric Administration in the U.S. Department of Commerce can provide technical advice and assistance in organizing and operating fishery cooperatives. The Cooperative League of the USA, in Chicago, and the Consumers Cooperative Publishing Company, in New York City, can provide publications on consumer cooperatives. Additional sources are the Consumer Cooperative Association, the American Institute of Cooperation, and National Cooperatives.

TAX EXEMPT STATUS FOR AREA DEVELOPMENT FINANCE ORGANIZATIONS

INTRODUCTION

Area development finance organizations may be formed as nonprofit corporations for the purposes permitted by State law. In most states, nonprofit incorporation does not mean that the corporation cannot generate revenues, rather, it generally cannot return earnings to members and members have no rights to corporate assets upon dissolution. A nonprofit corporation may be exempt from Federal income taxation, but it need not be. Certain charitable nonprofit corporations are eligible for Federal tax exemptions, but forming a nonprofit corporation does not automatically result in tax-exempt status under the Federal Internal Revenue Code. Although the scope of business activities in which exempt nonprofit corporations may engage is limited by their articles of incorporation under State statutes and self-dealing prohibitions and their unrelated business income is taxable, there are advantages allowing for a complex control structure and opening the way for financial support from a broad range of charitable sources.

State statutes should be checked to determine the specific provisions and procedures for forming a nonprofit membership corporation in any jurisdiction. Alternatively, an organization may be able to incorporate under the District of Columbia Non-Profit Corporation Act and qualify in another local jurisdiction.

Area development finance organizations can gain several benefits from taking advantage of the exemption from Federal income taxation available under Section 501 (c)(3) of the Internal Revenue Code. With such an exemption a finance organization formed as a charitable trust, or unincorporated association, or incorporated as a nonprofit corporation under applicable State law is in a much improved fund-raising position, since it is better able to secure charitable contributions from individuals and corporations. Contributions to an organization exempt under Section 501(c)(3) are deductible to the donor within the limits specified in Section 170 of the Internal Revenue Code. In addition, the organization's ability to obtain money from other exempt organizations will be enhanced, as indicated by reports that over ninety percent of foundation grant funds go to exempt organizations. Other exempt organizations, such as foundations and churches, minimize the risk of jeopardizing their own exemptions by making contributions and grants to exempt organizations, and private foundations most easily satisfy the Tax Reform Act requirement that they make minimal distribution of income for qualified purposes by making such distributions to other exempt organizations. Exempt organizations also may escape a host of State and local taxes and licensing requirements.

Although there are other subsections of Section 501(a) pursuant to which nonprofit corporations are exempted from Federal income tax, apart from Section 501(c)(4) these subsections are of no utility to a nonprofit area development finance organization. Even Section 501(b)(4), the exemption for social welfare organizations, is not a particularly desirable alternative, since contributions to organizations with that exemption are not deductible to their donors. Foundations, moreover, are not as willing to make grants to Section 501(c)(4) organizations as they are to those exempt under Section 501(c)(3). On the other hand, a foundation might view an organization with a Section 501(c)(4) exemption as preferable to one with no exemption at all. In general, organizations exempt under Section 501(c)(3) and 501(c)(4) are subject to the same restrictions on their operations, with one important exception - 501(c)(4) organizations may engage in lobbying and political activities, while a Section 501(c)(3) organization may not [a Section 501(c)(3) organization may engage in some insubstantial lobbying activities, while any political involvement is prohibited altogether].

An organization that has some activities that can qualify as charitable, and some that cannot, can use a dual organizational structure - this type of structure can consist of an exempt nonprofit organization with a holding company between it and for-profit subsidiaries for each business activity. Wholly-owned for-profit subsidiaries may be able to attract assistance unavailable to nonprofits, such as Small Business Administration loans and set-asides, and they can easily be divested, strengthening the parents' argument for continued tax exemption. The nonprofit need not be the sole owner of the for-profit subsidiaries, since, by definition, a wholly-owned subsidiary cannot raise capital from outside by selling stock. And, although a for-profit entity can receive bank and SBA loans, a wholly-owned subsidiary of a nonprofit may find banks reluctant to lend due to the nonprofit nature of its parent, while potential funding sources for the nonprofit parent may be similarly reluctant because they suspect utilization of grant money for profit-making activities.

QUALIFICATION FOR TAX EXEMPTION

Area development finance organizations formed to provide management assistance and financial assistance in the form of loans, guarantees, and equity investments to individual members of underprivileged groups and corporations in economically underprivileged areas, so they can own and operate businesses, can qualify as a tax-exempt charity.

Generally, a Section 501(c)(3) organization is presumed to be a private foundation unless it can demonstrate that it is publicly-supported to a substantial extent, and thus is classified as a public charity. There are basically two ways that a 501(c)(3) organization can establish itself as a public charity. One is to demonstrate that under either of two similar tests, more than one-third of its financial support is derived from public sources, which generally may be defined as any governmental source, other public charities, and the general public (within certain dollar or percentage limits per contributor). A second way that an area finance organization may demonstrate that it is public charity and not a private foundation is by satisfying a facts and circumstances test under Section 170 which stresses factors other than financial support. These factors in the Internal Revenue Regulations include the organization's fund-raising activities and the extent to which it is controlled by the public and makes its facilities and programs available to it. A genuinely broad-based organization will most likely be able to meet one of these tests.

Unless it is determined to be exempt from Federal income taxation under Section 501(c)(3) of the Internal Revenue Code, an organization formed as a nonprofit corporation under State law is, for Federal income tax purposes, treated as a for-profit corporation. If the exemption tests are not met, the organization may be found to be a private foundation potentially subject to six taxes. These taxes include an excise tax based on investment income and initial and additional taxes on self-dealing, failure to distribute income, excess business holdings, investments which jeopardize charitable purpose, and taxable expenditures. Except for the tax on investment income, all of these taxes are in effect graduated penalities designed to discourage certain types of activities not generally associated with area development finance organizations. The typical development finance organization will have little to fear from these tax provisions even if it is classified as a private foundation under Section 509 of the Internal Revenue Code [all 501(c)(3) organizations are private foundations unless they meet one of four exceptions].The most important of these potential tax penalties is the one on excess business holdings. Business holdings of a private foundation which exceed twenty or thirty-five percent of the enterprise's voting stock are potentially subject to this tax. It is probable, however, that a development organization can avoid taxation under this provision because the tax is not applied where the holdings are program-related investments as defined in Section 4944(c).

FILING FOR 501(c)(3) TAX-EXEMPT STATUS

Blank "Exemption Applications" (Form 1023), instructions for their completion, and copies of *How to Apply for Exemption for an Organization* (IRS Publication 557) are available from the office of the appropriate District Director of Internal Revenue. From 1023, which requires that the articles of incorporation and bylaws be attached as exhibits, must be filed in duplicate to obtain an official letter of determination as to tax-exempt status from the I.R.S. The services of a legal counsel should be obtained for the preparation of Form 1023 and the required supporting documentation. An attorney will have needed knowledge of and/or access to pertinent Treasury Regulations and Revenue Rulings, as well as the Internal Revenue Code.

As a public charity engaging in business development, employment and job assistance, housing assistance, marketing assistance, or similar activities, the nonprofit area development finance organization will be prohibited from certain political activities and financial transactions, but will be in a position to offer tax savings to individual, business organization, and private foundation donors of seed money.

NONPROFIT CORPORATION EXEMPTION FROM FEDERAL SECURITIES REGISTRATION

Section 3(a)(4) of the Securities Act allows exemption from the Federal securities registration requirement for securities issued by nonprofit corporations organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes. A nonprofit corporation cannot give financial benefit to its individual members or stockholders in any way and maintain an exemption under this Section of the Securities Act. Almost all states provide for a similar exemption for nonprofit corporations operating for specified purposes, with the requirement that no earnings of the issuer may inure to the benefit of a shareholder or any other individual. Several states have enacted exemptions specifically designed for use by nonprofit development corporations (i.e., Michigan, New York, and Virginia).

GLOSSARY
Financing Area Development

ABSTRACT--A document usually associated with real estate. The abstract lists the history of a parcel of land, starting with the original grant, and following through each transfer of title to the present title holder. It also recites all mortgages outstanding on the property, and any defects that would cause a "clouded" title in the chain of transfers. Abstracts are usually requested by mortgagees and prospective new title holders to real estate property.

ACCELERATION CLAUSE--A clause included in the body of a contract which stipulates that the entire balance owing shall become due immediately and payable in the event of a breach of certain other conditions of the contract, such as insolvency, or the debtor's failure to pay taxes on mortgaged property, etc.

ACCEPTANCE--A time draft (bill of exchange) on the face of which the drawee has written the word "Accepted" over his signature. The date and place payable are also indicated. The person accepting the draft is known as the *acceptor*. A *bank acceptance* is a draft drawn on and accepted by a bank. A *trade acceptance* is a draft drawn by the seller of goods on the buyer, and accepted by the buyer. A statement that the acceptor's obligation arises out of the purchase of goods often appears on the face of the draft.

ACCOMMODATION ENDORSEMENT--When a person signs or endorses a note or draft solely for the purpose of inducing a bank to lend money to a borrower whose credit is not substantial enough to warrant a loan, such an endorsement is called an accommodation endorsement. The endorser, while being liable to repay the amount in full, ordinarily does not expect to do so. He derives no benefit from the transaction, but acts as a guarantor or surety for the borrower. Another form of accommodation endorsement is the practice among banks of endorsing the acceptances of other banks for a fee, in order to make them acceptable for purchase in the acceptance market.

ACCOUNT--A record of all the financial transactions and the date of each, affecting a particular phase of the business expressed in debits and credits, evaluated in money, and showing the current balance, if any (the excess of debits over credits, or the excess of credits over debits).

ACCOUNTS PAYABLE--A current liability representing the amount owed by an individual or a business to a creditor for merchandise or services purchased on open account or short term credit.

ACCOUNTS RECEIVABLE--Money owed a business enterprise for merchandise bought on open account. (i.e., Without the giving of a note or other evidence of debt.)

"ACID TEST" RATIO--One of the most important credit barometers used by lending institutions, as it indicates the ability of a business enterprise to meet its current obligations. The formula used to determine the ratio is as follows:

$$\frac{\text{Cash plus Receivables plus Marketable Securities}}{\text{Current Liabilities}}$$

Frequently, a 1 to 1 ratio is considered satisfactory.

AMORTIZATION--The gradual reduction of a debt by means of equal periodic payments sufficient to meet current interest and liquidate the debt at maturity. When the debt involves real property, often the periodic payments include a sum sufficient to pay taxes and hazard insurance on the property.

AMORTIZED LOAN--A loan requiring periodic payments which are used to reduce the principal so that the loan will be repaid in full by a predetermined date.

ASSIGNED ACCOUNT--An account, such as an accounts receivable account, which has been assigned to a bank as security for a loan by the borrower. In theory, the bank actually takes possession of the account pledged, and when this account is paid by the borrower's customer, it should be paid directly to the bank to reduce the borrower's loan. In actual practice, and in order not to jeopardize the relationship between the borrower and his customer (whose account has been pledged), the bank will allow the account to be paid by the borrower in the normal manner, and rely upon the integrity of the borrower to apply this payment against the loan balance.

ASSIGNMENT, ASSIGNEE, ASSIGNOR–The transfer of title to certain property, usually securities, is accomplished by assignment of the property to another legal entity. A common example of this is found in the hypothecation of securities, wherein the assignment form usually contains the wording "sell, assign, and transfer unto." This is distinguished from the term *"endorsement"* wherein title to negotiable instruments is transferred with the delivery of the instrument. Another common term in banking is "Assigned Accounts Receivable." For its meaning see *"Assigned Account."*

The legal entity who assigns the property is known as the *assignor*, and the legal entity who takes title through assignment is known as the *assignee*.

AT SIGHT--A term used in the body of negotiable instruments indicating that payment is due upon presentation or demand.

BABY BONDS--Bonds whose denomination (face value) is usually of $100.00 or less.

BAD DEBTS--Commercially speaking, bad debts are the amounts due on open account that have been proved to be uncollectable. Financial institutions, as well as commercial enterprises, charge current operations with an amount (usually a given per cent of the total outstanding) which past experience indicates to be the amount (or percentage) of the accounts or loans outstanding that will be uncollectable. The amount charged to current operations is credited to an account termed "Reserve for Bad Debts."

BALANCE OF ACCOUNT--The amount required to equalize the total debits and total credits posted to a given account. Balances are of three types: *ZERO*–indicating that total debits and total credits are equal; *DEBIT BALANCE*–indicating the excess of total debits over total credits, and *CREDIT BALANCE*–indicating the excess of total credits over total debits, at a given moment of time.

BALANCE SHEET–An itemized statement which lists the total assets and the total liabilities of a given business to portray its net worth at a given moment of time. When statements of this nature are prepared by financial institutions, they are termed a *"Statement of Condition."*

BANK CREDIT–The credit created by commercial banks through the media of loans and discounts–granted with or without collateral. The amount of credit so extended is controlled in part by the rediscount rates established by the Federal Reserve Board.

BILL DISCOUNTED--A promissory note or bill of exchange from which the bank deducts, in advance, its fee or interest for lending the money (usually to the holder or endorser).

BILL OR EXCHANGE--A written order addressed by one person (the drawer) to another person (the drawee) directing the drawee to pay a specified sum of money to the order of a third person (the payee). It is signed by the drawer, and may be made payable either on demand or at a definite future date. The terms "bill of exchange" and "draft" are generally used interchangeably.

BILLS PAYABLE--A comprehensive term that includes the sum total of notes and trade acceptances which a business owes to trade creditors and which the business must pay at their maturity.

BILLS RECEIVABLE--A comprehensive term that includes the total of all notes and trade acceptances given by customers, usually in payment of merchandise, which the debtors must pay at maturity.

BONDS--An interest-bearing certificate of debt, usually issued in series by which the issuer (a government or corporation) obligates itself to pay the principal amount and interest at a specified time, usually five years or more after date of issue. Bonds may be distinguished from promissory notes or other evidences of debt because of their formal execution under seal and certification by a bank or trust company that they are authorized by the board of directors of a corporation, or other governing body. Corporate bonds are usually secured by a lien against certain specified property. Bonds may be issued in *"bearer"* form or *"registered."*

BOND (BEARER)–A bearer bond is one which is redeemable by the holder or bearer, and which has coupons attached to it calling for payment of interest at specified times. These coupons are detached from the bond on the specified dates, and collected through the holder's bank.

BOND (REGISTERED)--A registered bond is one in which the name of the owner is designated, and the proceeds are payable only to him. Bonds may be registered as to principal and interest, or to principal only. Interest on a bond registered as to both principal and interest, is paid to the owner by check as it becomes due. Bonds registered as to principal only, have coupons attached which are detached and collected as the interest becomes due.

BOND POWER--A "Power of Attorney" used in connection with the sale and transfer of registered bonds. It is necessary to obtain bond powers whenever registered bonds are pledged as collateral.

BONDS (VARIOUS TYPES OF):

Collateral Trust Bond–An issue of bonds for which collateral has been pledged to guarantee repayment of the principal. This type of bond usually arises out of inter-company transactions where the parent company will issue bonds with securities of a subsidiary as the underlying collateral. Railroads often do this type of financing.

Convertible Bond--A bond which gives to its owner the privilege of exchanging it for other securities of the issuing corporation on a preferred basis at some future date or under certain conditions.

Debenture Bond–A bond for which there is no specific security set aside or allocated for its repayment.

Definitive Bond–This term applies to any bond issued in final form. It is used particularly with reference to permanent bonds for which Temporary Bonds or Interim Certificates were issued.

Guaranteed Bond--Bonds on which the principal or income or both are guaranteed by another corporation or parent company in case of default by the issuing corporation.

Income Bond–Type of bond on which interest is paid only if and when earned by the issuing corporation. The interest in some cases may be cumulative.

Interim Certificate--Also called "Interim Bonds" or "Temporary Bonds." These are issued prior to the issuance of permanent bonds, when the holder or subscriber requires tangible evidence of ownership. These certificates or bonds sometimes have interest coupons attached, if an interest period should occur before the issuance of the permanent bond.

Mortgage Bond--Bonds which have as an underlying security a mortgage on all properties of the issuing corporation. This mortgage is usually subject to prior liens.

Serial Bond–An issue of bonds in which a certain proportion of the bonds are retired at regular intervals. Serial bonds are issued where the security depreciates through use or obsolescence, and they usually provide that the bonds outstanding shall not exceed the value of the security.

Sinking Fund Bonds--Bonds secured by the deposit at regular intervals of specified amounts with the trustee. The issuing corporation makes these deposits to secure the principal of the bonds and it is sometimes required that the funds be invested in other securities.

BORROWER--Any *legal entity* an individual, proprietorship, partnership, corporation, or organization–who obtains funds from the lender by the extension of credit for a period of time for a consideration. The borrower signs a note as evidence of the indebtedness.

CALL LOAN--Loans which may be terminated at the discretion of the borrower or the lender. Call loans are confined to exchange brokers (stock or commodity) and are sometimes known as "street loans" or "stock exchange loans." Strictly speaking, all call loans may be subject to immediate termination by borrower or lender, but in actual practice they fall into two specific groups: loans at "sharp call" and those at "slow call." "Sharp call" loans are those in which the prerogative of the lender to call is exercised indiscriminately. "Slow call" loans usually come under a gentleman's agreement that the loan will not be called except as a last resort. Since the statutory limit on interest rates does not apply on call loans of over $5,000, the rate will often rise to considerably in excess of the legal limit of 6% (New York State law), where corporations and others are debarred from pleading usury.

CALL MONEY--Money loaned by banks to brokers which is subject to call (demanded payment) at the discretion of the lender.

CALLED BONDS--While bonds generally are not called for redemption before maturity, there are cases when this is done by corporations or government agencies, and the fact that they are subject to call is recorded in the terms of the bonds. The process of calling bonds for redemption is handled by lot or otherwise, and the bonds drawn for redemption are known as called bonds.

CAPITAL--The amount subscribed and paid by stockholders to permit a bank to function as such. Capital requirements of banks, both national and state, are governed by the size of the community in which they are chartered to operate. Supervisory authorities determine the amount of capital necessary for a bank to start operations in a given locality. In all cases, capital must be fully paid in cash before a bank is allowed to open for business. Shareholders of national banks and some state banks must pay a premium for the capital stock purchased, this premium being applied to the establishment of a paid-in surplus.

CAPITAL ACCOUNT--An account maintained in the name of the owner, or owners of a business and which indicates his or their equity in that business–usually at the close of the last accounting period.

CAPITAL ASSETS--A collective term which includes all fixed assets, consisting of Furniture and Fixtures, Land, Buildings, Machinery, etc.

CAPITAL INVESTMENTS--A collective term representing the amounts invested in capital or fixed assets, or in long term securities as contrasted with those funds invested in current assets or short term securities. Generally speaking, capital investments include all funds invested in assets which, during the normal course of business, are not expected to be realized upon during the ensuing fiscal period.

CAPITAL LIABILITIES--A comprehensive term which includes all long-term indebtedness of a corporation which is represented by the outstanding capital stock (liability to owners) and mortgages and bonded indebtedness (liability to outside creditors). Generally, a long-term indebtedness is considered as one which, during the normal course of the business, will not fall due or be liquidated during the ensuing fiscal period.

CAPITAL STOCK (Commercial Business)--The specified amount of stock which a corporation may sell as authorized by the State granting the corporation charter. If the stock has a stated value per share, such value is known as "par value." Stock without a designated value is referred to as "no par value" stock.

CAPITAL TURNOVER–A term commonly used by the Credit Department of a lending institution which represents the number of times the outstanding capital has "turned over" in relation to the net sales for a given period of time, frequently a year. Example: if the net sales for a given period are $200,000, and the outstanding capital is $60,000, the capital turnover in this period was 3-1/3 times. The capital turnover of each type of business that has operated successfully for a period of years has been reasonably well established and is referred to as the "normal" turnover for that particular type of business. A capital turnover in excess of this "norm" is an indication that the business is being managed with better than average efficiency.

CAPITALIZATION–Total amount of the various securities issued by a corporation. Capitalization may include bonds, debentures, preferred and common stock. Bonds and debentures are usually carried on the books of the issuing company in terms of their pay or face value. Preferred and common shares may be carried in terms of par or stated value. Stated value may be an arbitrary figure decided upon by the directors or may represent the amount received by the company from the sale of the securities at the time of issuance.

CASH DISCOUNT–A deduction from the selling price permitted by the seller for merchandise sold on credit, represented in terms of a percentage (commonly 2%, 10 days), that is made to encourage the more prompt payment of the invoice covering the goods or services purchased.

CASH ITEM--Any item immediately convertible into cash. The term also includes all items not in the form of cash, which are held in a general ledger account titled "Cash Items" pending conversion into cash.

CENTRAL LIABILITY–The grouping together on one record of all liabilities of a borrower, such as loans both direct and indirect, consumer credit, letters of credit, guarantees, and other accommodations. The purpose of this record is to prevent over-extensions of credit to the borrower.

CERTIFICATE OF DEPOSIT (DEMAND)--A receipt issued for funds deposited with a bank, and payable on demand of the holder. These receipts do not bear interest, and are used principally by contractors and others as a guaranty of performance of a contract, or as evidence of good faith when submitting a bid for the sale of merchandise to a governmental agency. They may also be used as collateral for a loan.

CERTIFICATE OF DEPOSIT (TIME)--A receipt for funds deposited with a bank, payable to the holder at some specified date (not less than 30 days after issuance) and bearing simple interest. Banks may require notice (not less than 30 days) before repayment.

CHATTEL MORTGAGE--A mortgage on movable goods or equipment. Chattel mortgages are quite extensively used in two forms of bank financing: for consumer credit financing of automobiles, refrigerators, television sets, other household appliances, etc; and for the financing of railroad equipment.

COGNOVIT NOTE--A form of note (legal evidence of indebtedness) which is both a promissory note and chattel mortgage. The borrower, within the wording of the instrument, waives his right of action to the chattel property in case of his default in any payments agreed to in the transaction.

COLLATERAL--Stocks, bonds, evidences of deposit, and other marketable properties which a borrower pledges as security for a loan.

COLLATERAL NOTE--A promissory note which specifically mentions the collateral deposited by the borrower as security for the repayment of the loan.

CO-MAKER--A person who signs a note in addition to the borrower to give extra security to the loan, because of the weakness of the borrower as an individual credit risk. The term is generally used in connection with industrial loans for personal use, where the loans do not have mortgages as the underlying security. A co-maker is distinguished from an endorser or guarantor, in that in a legal sense he is jointly liable with the borrower for repayment of the loan, while an endorser or guarantor is required to make good the loan only after certain legal technicalities have been fulfilled.

COMMERCIAL LETTER OF CREDIT--Letters of credit issued to facilitate the purchase of goods. Many businesses use Commercial Credits to purchase merchandise and insure prompt shipment, because the responsibility of the issuing bank is behind the credit.

COMMERCIAL LOAN--Commercial loans are principally loans made to businesses for the financing of inventory purchases and the movement of goods, as distinguished from personal loans or consumer credit loans. Commercial loans are short-term time loans, or acceptances (time drafts accepted).

COMMERCIAL PAPER--This term applies to notes and acceptances originating from commercial transactions (the transfer and movement of goods). These are usually notes or acceptances with a definite maturity date, which are received by a business enterprise in payment for goods sold or services rendered.

COMMITMENT--An advance agreement to provide funds for mortgage loans.

COMMON SIZE STATEMENT--This refers to the device used in comparing statements, especially a statement from a small-sized concern with a statement of a concern many times larger in a similar line of business. To avoid misinterpretation and confusion frequently encountered while dealing with large amounts, the device operates as follows:

The total value of each individual item (asset) is divided by the total of all like items (total assets), thus reducing each figure to a percentage of the whole.

These computations are made for all items appearing on all statements (or reports) being compared, and then the resulting percentages are used for comparison rather than their dollars and cents values.

Frequently, there is a need for analyzing a statement for which there are no figures from like concerns available.

COMPARATIVE STATEMENT--The income, expense, profit and loss, balance sheet or other financial statement of the same concern for two or more consecutive years that are analyzed to determine the increase or decrease in their component items, frequently for credit purposes.

CONTINUING GUARANTY--A form given to a bank by a person to guarantee repayment of a loan to another party. This guaranty promises payment by the guarantor in the event of default by the borrower, and is so worded that it may apply to a current loan, or to one made at a later date. The guaranty may or may not pledge collateral as security for the loan.

CONVEYANCE--Broadly speaking, this term is used to describe the transfer by mortgage, deeds, bill of sale, etc., of title of property from one party (the seller) to another (the buyer).

COOPERATIVE--A system of indirect ownership of a single unit in a multiunit structure. The individual owns shares in a nonprofit corporation which holds title to the building; the corporation in turn gives the owner a long-term proprietary lease on the unit.

CO-OPERATIVE BANK--The legal title used by state-chartered savings associations in Massachusetts and less frequently in New Hampshire, Rhode Island and Vermont.

COUPON--Non-registered bonds are negotiable in that they may be transferred in title from one person to another. The evidence of interest payable on the bonded indebtedness is a portion of the bond itself. This portion of the bond is composed of a series of small sections, each dated serially for future payment dates. These small sections, when cut or "clipped" from the bond on the date specified, are called coupons, and are also negotiable "bearer" instruments. The coupon recites the terms of the payment and the legal entity which issues the bond, the date and place of payment, and the number of the bond from which the coupon was clipped.

CREDIT--A term associated with the ability of a *legal entity* to borrow from a lender. The extension of credit is based upon the lender's faith and confidence in the borrower's promise to repay the funds borrowed from the lender. Usually this faith and confidence is based upon the lender's knowledge of the borrower's past performance in repaying debts, the borrower's financial history, his assets, standard of living, and manner of conducting business.

CREDIT MEMO

1. A posting medium authorizing the credit to a specified account of a certain named amount which bears the complete description of the transaction, the date, and the signature of the party responsible for the authorization of the credit.

2. A detailed memorandum forwarded from one party or firm to another, granting credit for returned merchandise, some omission, overpayment, or other cause.

CREDIT RATING

1. The amount, type, and terms of credit, if any, which the credit department estimates can be extended to an applicant for credit.

2. An estimate as to the credit and responsibility assigned to mercantile and other establishments by credit investigating and credit servicing organizations.

CREDIT RISK

1. The degree of risk calculated by the credit department that is connected with a particular request for credit.

2. The degree of risk assumed for the possible non-payment of credit extended.

CURRENT ASSETS--Those assets of a company which are reasonably expected to be realized in cash, or sold, or consumed during the normal cycle of the business. These include cash, U.S. Government bonds, receivables and money due usually within one year, and inventories.

DAY LOAN--This is a loan made for one day only for the convenience of stock brokers. The loan is granted for the purchase of securities. When the securities are delivered, they are pledged as collateral to secure a regular call loan. In this manner, the purchase of securities is financed during a few hours of the business day. This type of transaction is also known as a "clearance loan" or "morning credit."

DAYS OF GRACE--The reasonable length of time allowed, without suffering a loss or penalty, for postponed payment or for the presentment for payment of certain financial documents.

DEBENTURE--A term used to define indebtedness, usually in long term obligations, which is unsecured. A debenture is found in bonded indebtedness for which no security has been pledged other than the integrity of the issuer of the bond.

DEBIT--A debit is any amount in dollars and cents that, when posted, will increase the balance of an asset (resources) or expense account, and will decrease the balance of a liability or an income account. All asset and expense accounts normally have debit balances and all liability, capital, and income accounts normally have credit balances. Examples: checks drawn on the bank account of depositors are debits, because they decrease a liability account balance when posted; deposits are credits because they increase a liability account balance when posted. New loans are debits because they increase an asset account balance, while paid-off loans are credits since they decrease an asset account balance when posted.

DEFAULT--The failure to do that which is required by law, or to perform on an obligation previously committed. The term is commonly used when some legally constituted governing body fails to pay the principal or interest on its bonds, or to meet other financial obligations on maturity.

DEFICIT

1. The excess of liabilities over assets (negative net worth).

2. A term used indicating obligations or

expenditures for items which are in excess of the amount allotted for those items in a financial budget.

3. The excess of obligations and expenditures as a whole affecting a given budget period which is in excess of the budget established for the period.

DEMAND LOAN--A loan that has no fixed maturity date, but which is payable upon demand of the bank making the loan. Interest accruing on a demand loan is earned before it is paid by the borrower, who is billed by the bank on a monthly or quarterly basis for the interest earned and due to the bank. Demand loans can be "called" by the bank at any time that the bank desires payment.

DIRECT REDUCTION MORTGAGE--(also called "D.R.M."). A direct reduction mortgage is liquidated over the life of the mortgage in equal monthly payments. Each monthly payment consists of an amount to cover interest, reduction in principal, taxes, and insurance. The interest is computed on an outstanding principal balance monthly. As the principal balance is reduced the amount of interest becomes less, thereby providing a larger portion of the monthly payment to be applied to the reduction of principal. As taxes and insurance are paid by the mortgagee (lending association), these disbursements are added to the principal balance. This procedure follows throughout the life of the mortgage.

DISCOUNT--The amount of money deducted from the face value of a note. The borrower receives the net amount after the discount has been deducted. The discount is computed at the rate of interest agreed upon. Technically this is called "banker's discount" for it includes "interest on interest." True discount offers the borrower a very small advantage over "banker's discount." The term may also be used as a noun, the banker referring to his portfolio of "discounts," meaning his discounted notes. The term discount also refers to discounts on securities. Securities are bought and sold either at a discount (at less than par); they are purchased at par (at face value); or they are purchased at a premium (the buyer pays a price higher than the face or par value in order to acquire them); in foreign exchange, the term (discount) is used to describe the relationship or one currency to another. As an example: Canadian Currency may be at a discount to United States Currency.

EQUITY--The ownership interest of common and preferred stockholders in a company. Also refers to excess of value of securities over the debit balance in a margin account.

EXPENDITURE--An actual payment, or the creation of an obligation to make a future payment for some benefit, item, or service received. If the expenditure was for the purpose of acquiring or improving a relatively permanent asset, it is termed a "capital expenditure." If the amount involved should be charged to some operating account, it is termed a "revenue expenditure."

FACE VALUE--The par value, the monetary value, or the principal value of an instrument is known as its face value. It is upon the face value that interest is computed on interest-bearing obligations, such as notes, bonds, mortgages, etc. The individual or other legal entity who issues a note, bond, or other obligation, contracts to repay the face value of the obligation at maturity. Bonds, as an example, when issued, are purchased either at a premium, at par (or face value), or at a discount. The theory of bonded indebtedness is that regardless of what the purchase price may have been, the confidence in the maker should be such that the market value and the face or par value should converge and meet at maturity, when the face value of the obligation is to be paid in full.

FEDERAL HOME LOAN BANK (FHLB)--One of the 12 federally chartered regional Banks of the Federal Home Loan Bank System. A Bank's primary function is to supply credit to member institutions.

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA)--A government-sponsored private corporation which supplements private mortgage funds by buying and selling FHA and VA loans.

FEDERAL RESERVE NOTE--When certain areas require large volumes of currency, or in seasons of the year when the public demand for currency is very heavy, the Federal Reserve banks have the power under the Federal Reserve Act to issue notes. When the need for currency relaxes, the Federal Reserve banks retire these notes. Federal Reserve notes are issued to member banks through their Federal Reserve bank. The Federal Reserve bank obtains the notes through its Federal Reserve agent, a government representative, by pledging gold certificates, certain types of eligible paper, and/or United States government obligations. The Federal Reserve bank must, however, have in its possession, or pledged with the Federal Reserve agent, at least

25% of the Federal Reserve note issue backed by gold certificates, plus another 25% in gold certificates of the deposit liability of the bank. Federal Reserve notes are issued only in denominations of five, ten, twenty, fifty, one hundred, five hundred, one thousand, five thousand, and ten thousand dollars. Federal Reserve notes answer the need for an elastic currency with full legal tender status. Today seven-eighths of the dollar volume of all United States currency is in Federal Reserve notes.

FEDERAL SAVINGS AND LOAN ASSOCIATION--A savings association chartered and regulated by the Federal Home Loan Bank Board.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION (FSLIC)--An instrumentality of the federal government which insures the savings accounts in member institutions. It is similar to the Federal Deposit Insurance Corporation, which insures savings deposits in commercial banks.

FIDUCIARY--An individual, corporation, or association, such as a bank or trust company, to whom certain property is given to hold in trust, according to the trust agreement under which this property is held. The property may be utilized, or invested for the benefit of the property owner to the best ability of the fiduciary. Administrators and executors of estates, trustees of organizations, are common examples of fiduciaries. Investments of trust funds, unless specified in the trust indenture, are usually restricted by law.

FINANCIAL INTERMEDIARY--A financial institution which acts as an intermediary between savers and borrowers by selling its own obligations for money and, in turn, lending the accumulated funds to borrowers. The classification includes savings associations, mutual savings banks, life insurance companies, credit unions and investment companies.

FINANCIAL STATEMENT--Any statement made by an individual, a proprietorship, a partnership, corporation, organization, or association, regarding the financial status of the *legal entity*. The financial statement of an individual would be a simple listing of what he owns (his assets), what he owes (his liabilities), his net worth, and his source of annual income and the amount. The financial statement of a large corporation or business firm may include many subsidiary financial statements prepared by a certified public accountant

FIXED ASSETS--Those assets of a permanent nature required for the normal conduct of a business, and which will not normally be converted into cash during the ensuing fiscal period. Example: furniture and fixtures, land, buildings, etc.

FIXED CAPITAL--Capital invested in Fixed Assets, such as Land, Buildings, Machinery, etc.

FIXED CHARGES

1. The financial expenses that must be paid when they become due and payable.

2. Those expenses or charges that are normal for a given type of business, and which must be paid in order to engage in that type of business. Example: Certain enterprises must obtain certain licenses each year in order to begin and continue business.

FIXED LIABILITIES--Includes all liabilities which will not mature within the ensuing fiscal period. Example: Mortgages due 20 years hence, bonds outstanding, etc.

FUNDED DEBT--Usually interest-bearing bonds of a company. Could include long term bank loans. Does not include short-term loans, preferred or common stock.

GOOD WILL--That intangible possession which enables a business to continue to earn a profit which is in excess of the normal or basic rate of profit earned by other businesses of similar type. It might be due to its particularly favorable location; its reputation in the trade; the quality of the employer and employee relationship; its monopolistic privilege, or a combination of any of these and other favorable conditions. The evidence that Good Will exists is the proven ability to earn excess profits.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA)--A government corporation established by the Housing Act of 1968 that assumed the special assistance and management and liquidation functions of the Federal National Mortgage Association.

GROUP BANKING--A term used to describe a form of banking enterprise whereby a group of existing banks form a holding company. The holding company supervises all the banks in the group, and co-ordinates the operations of all banks in the group through uniform procedures. Each bank in the group has its own directorate and group of officers, with the holding company having a staff of officers and employees to carry out the function of the holding company. A majority of the capital stock of each bank in the group is owned by the holding company.

GUARANTY--A contract, agreement, or undertaking involving three parties. The first party (the guarantor) agrees to see that the performance of a second party (the guarantee) is fulfilled according to the terms of the contract, agreement, or undertaking. The third party is the creditor, or the party to benefit by the performance. As an example: Party B makes a loan through his bank. The bank desires a guarantor for this loan in case of default by B. B asks A to act as guarantor for his loan. A agrees, and endorses B's note. A is the guarantor, B is the guarantee, and the bank is the creditor.

The term guaranty is also used in connection with requests by other banks asking a bank to guarantee alterations, endorsements, and signatures on checks or other instruments before the paying bank will accept them as complete negotiable instruments.

HOLDING COMPANY--A corporation which owns the securities of another in most cases with voting control.

INDEPENDENT BANK--An independent bank is one which operates in one locality. The directors and officers are generally local men of the community. If the local bank operates branches, these will be located in the same city as the central office, except in states where state-wide branches are permitted, in which case the independent bank may have state-wide branch offices. Independent banks are to be distinguished from chain or group banks.

INDUSTRIAL BANK--A financial institution that derives its funds through a form of savings known as "investment shares," and invests these funds by specializing in the financing of business through the assignment of plegded accounts receivable.

INFIRMITY--Any known act, or visible omission in detail, in the creation or transfer of title that would invalidate an instrument, is known as an infirmity. Common examples of infirmities that would invalidate an instrument and cause a bank to refuse payment, if detected, are endorsement missing, signature missing, amount missing, amount conflicting in written and numerical figures, any alteration, or forgery.

INSOLVENCY--The inability to pay one's debts as they mature. Even though the total assets of a business might exceed its total liabilities by a wide margin, the business is said to be insolvent should the nature of the assets be such that they cannot be readily converted into cash to meet the current obligations of the business as they mature.

INSTRUMENT--A written document in which some right is conferred, or some contractual relationship is expressed.

INTANGIBLE ASSET--An asset which has no substance or physical body; it is incorporeal. The most widely known types of intangible assets are known as "Goodwill" and "Patent Rights." These assets are purchased, sometimes for very substantial outlays of capital. Their value to the purchaser lies in the use he can make of them, although they cannot be seen. A purchaser buys "Goodwill" in order to take over a business which has enjoyed a fine business reputation for several years. The purchase price of "Goodwill" is determined by the profits a business has enjoyed due to business ethics, quality of the product handled, or desirable location.

"Patent Rights" permit a manufacturer to use a patent to his advantage, the patent right being transferred for a consideration by the inventor or holder of the patent right.

INTEREST--The price paid for the borrowed use of a commodity, especially money, is called interest. It has also been termed the "rental payment" for money borrowed. Interest is computed on a per centum rate of the principal borrowed for a given period of time. There are two kinds of interest–simple and compound. Simple interest is the price paid for money for a period of time based upon the principal. Compound interest is the price paid by the borrower based upon the principal plus the accrued interest over a period of time. Banker's interest is generally computed on the amount of interest earned and accrued daily: i.e., 1/360th of the interest at the agreed upon per centum rate for the actual number of days a loan is made.

INTEREST EARNED BUT NOT COLLECTED--Another name for "Interest Receivable." This represents interest on loans which has not been collected in advance, but is due and payable at specified times.

INTERMEDIATION--The process occurring when savers place funds in financial institutions in the form of additions to savings or time accounts. The financial institutions, acting as intermediaries, in turn place the funds in both loans and investments.

INVENTORY--The name given to an asset of a business. Inventories are of two general types: direct and indirect. Direct inventory in an industrial concern consists of raw materials, work-in-process, and finished goods. These inventories are in various stages of fabrication. Direct inventories in commercial and retail businesses are inventories purchased for resale. Indirect inventories, in general, are all supplies used to carry on the business and not purchased for resale. Indirect inventories are usually considered as deferred assets. The financing of inventory purchases comprises the most important function in commercial banking.

INVESTMENT BANKING--A term used to describe the financing of the capital requirements of an enterprise rather than the current "working capital" requirements of a business. Investment bankers buy and sell securities, such as stocks, bonds, and mortgages. They act as the "middle men" between the corporation who wishes funds for new buildings, new equipment, plant expansion, etc., and the investor, who wishes to invest his savings. Investment bankers may promote a new industry; they may handle the finances of a corporation for expansion purposes; and they may act as brokers with other investment bankers in the flotation of stocks and bonds.

INVESTMENT TRUST--A company which uses its capital to invest in other companies. There are two principal types: The closed-end and the open-end, or mutual fund. Shares in closed-end investment trusts, some of which are listed on the New York Stock Exchange, are readily transferable in the open market and are bought and sold like other shares. Capitalization of these companies is fixed. Open-end funds sell their own new shares to investors, stand ready to buy back their old shares, and are not listed. Open-end funds are so-called because their capitalization is not fixed; they issue more shares as people want them.

IRREDEEMABLE BONDS--Bonds issued which contain no provision for their being "called" or redeemed prior to their maturity date.

LAWFUL RESERVE--Banking laws establish the lawful reserves that must be maintained by banks for the protection of depositors' accounts. These reserves were established by the Federal Reserve Act and amendments contained in the National Bank Act of 1933 and 1935 for national banks, and by the banking laws of the various states for state-chartered banks. The Federal Reserve Board is vested by law with the power to change the lawful reserve for national banks in order to control the supply of credit throughout the United States. This Board may increase the reserve requirements in order to curtail the extension of credit, or it may decrease the reserve requirements in order to permit the expansion of credit. The lawful reserve for national banks is as follows:

	Minimum%			Maximum%
Time Deposits, all banks . . .	3%	up	to	7½%
Demand Deposits:				
Central Reserve Cities . .	13%	up	to	30%
Reserve Cities	10%	up	to	24%
Country banks (non-reserve cities)	7%	up	to	18%

The various state laws follow a similar pattern, being more strict in some respects and less strict in others. The lawful reserves are required to be available at all times in the form of cash, and under certain conditions, government securities, either in the vaults of the bank, or in lawful bank depositories authorized by government or state officials.

LETTER OF CREDIT--An instrument or document issued by a bank on another bank or banks, foreign or domestic, or upon itself. The letter of credit gives the buyer (probably unknown to the seller) the prestige and the financial banking of the bank who issues the letter of credit in his behalf. The acceptance by the bank of drafts drawn under the letter of credit satisfies the seller and his bank in the handling of the transaction. The buyer and the accepting bank also have an agreement as to payment for the drafts as they are presented.

LIMITED LIABILITY--The extent of the liability of the owners of a business (financial or other) to outside creditors. The liability of the stockholders of a commercial (as opposed to financial) corporation is limited to the par value of the stock they have subscribed for or own. In certain States, the liability of the stockholders of stock in a State-chartered bank is double the amount of the par value of the stock they have subscribed for or own.

LINE OF CREDIT--An agreement between a bank and a customer whereby the bank agrees to lend the customer funds up to a previously agreed maximum amount. The bank has the option to withdraw from the agreement if the financial status of the borrower changes, or if the borrower fails to use the line of credit for its intended use as per the agreement. The customer may borrow as much of the "line" as is required and pays interest on the borrowed portion only. A line of credit is widely used by large organizations for the future commitments and purchases of inventory. The bank is fully entitled to periodic financial reports from the borrower so as to be constantly informed on his credit status.

LIQUIDATING VALUE--The anticipated value of a particular asset that will be realized in case of liquidation of a business.

LIQUIDATION--The final or conclusive winding up of the affairs of a business by converting all assets into cash, paying off all outside creditors in the order of their preference, and the distribution of the remainder, if any, to the owners in proportion, and in the order of preference, if any, of ownership.

LIQUIDITY--A term used to describe the solvency of a business, and which has special reference to the degree of readiness in which assets can be converted into cash without loss.

LOAN--A business transaction between two *"legal entities"* whereby one party, known as the lender, agrees to "rent" funds to the second party, known as the borrower. The funds may be "rented" with or without a fee. This fee is called interest or discount in banking circles. Banks are the principal lenders of funds for commercial purposes. Loans may be demand or time loans, depending upon the agreement as to maturity. They may also be secured, the loans are supported by hypothecated securities acceptable to the lender, and these securities may be used by the lender to recover payment in case of dishonor by the borrower. Loans may also be short term loans or long term loans. Short term loans are evidenced by a promissory note, a trade acceptance, or other type of negotiable instrument. Long term loans are evidenced by bonds, mortgages, debentures, chattel mortgages, automobile liens, bailment lease agreements, or other certificates of indebtedness. The documents used in long term paper are legal evidences of indebtedness, and will stipulate the agreement made, the reason for the indebtedness, the manner of payment, and the rights of the lender in case of default by the borrower. Long term loans are generally outside the provisions of bank charters, and are therefore handled by other lending agencies.

LOAN APPLICATION--A form used by banks to record the formal request for a loan by a borrower. The form is especially designed by each bank to incorporate the necessary information that the bank desires having on record. The loan application may be a simple form or a more complex form containing information relative to the assets, liabilities, income, insurance, and contingent obligations of the borrower, as well as the purpose for which the loan is intended.

LOAN DEPARTMENT--The department of the bank where all the paper work as well as the actual loan transactions are handled. All notes and other negotiable instruments are filed in this department. All collateral securities are also filed in this department, which is bailee or custodian of these instruments and securities. The "Loans Made Register," the record of original entry for all loans, is created here. The note notice and maturity tickler are filed here for ready reference. The liability ledger containing the complete loan record of each borrower is made and kept in this department. This department is the principal source of revenue for the operations of the bank.

LOAN FUNCTION--The processing of a loan, covering each step necessary to furnish all required information. The following steps in the processing of a loan come under the loan function:

1. Interview between customer and loan officer.

2. Credit information assembled and placed in the customer's credit file.

3. Review of the credit information by the loan officer or loan committee.

4. Decision to extend credit to the customer.

5. Note processed by the loan teller and disbursement made to the borrower.

6. Loan recorded in the "Loans Made Register."

7. Customer's liability ledger, note notice, and maturity tickler recorded.

8. Note notice filed by customer; maturity tickler filed by due date.

9. Collateral and note filed for ready reference and accessibility.

10. Note and collateral, if any, surrendered to customer upon payment of loan.

11. Payment recorded in liability ledger; customer's ledger card kept for reference for future credit extension.

LOAN OFFICER--An officer of the bank who is designated with the responsibility of interviewing customers who may become borrowers. Certain officers of a bank are designated upon their appointment by the board of directors of the bank to have the power to grant loans to customers within certain specified amounts. Large loans are approved by a Loan Committee consisting of appointed officers and directors of the bank.

MAKER--Any individual, proprietorship, corporation, or other legal entity who signs a check, draft, note, or other type of negotiable instrument as a primary responsible party is known as the maker.

MARGIN--The difference between the market value of collateral pledged to secure a loan and the face value of the loan itself is known as margin. Margin requirements are set by each bank, and this ratio must be maintained by the borrower to keep adequate security pledged to the bank for the life of the loan. The control over margin requirements by the Federal Reserve Board is another control over credit extension exercised over national banks.

MARGIN CALL--If a borrower has securities pledged as collateral for a loan, and a declining market for the securities forces the value of the securities downward, then the bank must see that the margin requirements are met. The bank will request more margin from the borrower, who will either have to pledge more collateral, or partially pay the loan so that the collateral pledged will be sufficient to meet the established margin requirements.

MATURITY--The date upon which a note, time draft, bill of exchange, bond, or other negotiable instrument becomes due and payable. Notes, time drafts, and bills of exchange drawn for a future date, have a maturity date which is set, starting with the date of the loan or acceptance, and running the specified number of days from date of loan or acceptance to maturity. Presentation and request for payment of the instrument is made on the maturity date.

MEMBER BANK--All national banks, and any state bank that has applied for membership, and has been accepted as a member of the Federal Reserve System is called a member bank. Member banks are required to purchase capital stock in the Federal Reserve bank in their district equal to 6% of the total paid-in capital and surplus of the member bank. Fifty per cent of the capital stock purchased is paid for and carried on the books of the member bank as an asset. The remaining fifty per cent is not recorded on the books, but this subscribed portion may be called by the Board of Governors of the Federal Reserve System at any time.

MORTGAGE--A mortgage is an instrument of conveyance (generally of real estate) from a borrower, called the mortgagor, to the lender, called the mortgagee. The mortgage is only a "conditional" conveyance, in that the property remains with the use and occupancy of the mortgagor as long as the mortgagor lives up to the conditions of the mortgage. The major conditions are the continual payment of interest and principal reduction as set forth in the wording of the mortgage. When the money is loaned by the mortgagee to the mortgagor, the mortgage is signed by the borrower or mortgagor, and given to the mortgagee who has the right to foreclose the mortgage, or exercise his right to take over the property, in case the mortgagor fails to meet his obligations under the terms of the mortgage. The mortgage should always be filed in the records of the county seat where the real estate property is located.

MORTGAGE BANKER--A banker who specializes in mortgage financing; an operator of a mortgage financing company. Mortgage financing companies are mortgagees themselves, as well as being mortgage agents for other large mortgagees. Serving as mortgage agents, these mortgage bankers collect payments, maintain complete mortgage records, and make remittances to the mortgagees for a set fee or service charge. They also disburse funds for taxes, insurance, etc., as *escrow agents.*

MORTGAGE LOAN--A loan made by a lender, called the mortgagee, to a borrower, called the mortgagor, for the financing of a parcel of real estate. The loan is evidenced by a mortgage. The mortgage sets forth the conditions of the loan, the manner of repayment or liquidation of the loan, and reserves the right of foreclosure or repossession to the mortgagee. In case the mortgagor defaults in the payment of interest and principal, or if he permits a lien to be placed against the real estate mortgaged due to failure to pay the taxes and assessments levied against the property, the right of foreclosure can be exercised. Mortgage loans fall into four general categories:

1. Regular mortgages (National Banks).

2. Regular mortgages (State Banks).

3. F.H.A. mortgages.

4. Veterans' "G.I." mortgages.

For current specific information, refer to copy of the present law or laws pertaining to rules and regulations regarding these mortgages.

MUTUAL SAVINGS BANK--A banking organization without capital stock, operating under law for the mutual benefit of the depositors. A mutual savings bank is operated by a board of trustees. The depositor is encouraged to practice thrift, and the savings of these small depositors are invested in very high grade securities and some first class mortgages. Dividends from these investments are mutually distributed after expenses of the association and reserves for a guaranty fund for depositors have been deducted. The principal idea of a mutual savings bank is to perform a social service for small depositors who cannot risk their savings and who cannot invest their savings through their own knowledge without proper counsel.

OPEN-END MORTGAGE--A mortgage under which the mortgaged property stands as security not only for the original loan but for future advances which the lender may be willing to make.

OVER-EXTENSION

1. Credit received or extended beyond the debtor's ability to pay.
2. The condition where a dealer in securities obligates himself for an amount beyond his borrowing power or ability to pay.
3. The expansion of buildings, equipment, etc., by a business concern which is in excess of its present or prospective future needs.

PAR--When the exchangeable value of an instrument is equal to that expressed on its face without consideration to any premium or discount, that value is considered as par.

PARTICIPATION LOAN--Limitations have been set up by banking laws whereby banks are not permitted to lend more than a fixed per cent of their capital and surplus to any one borrower. (In most states, this fixed per cent is approximately 10%.) This limitation causes banks to invite other banks to participate in making a large loan. If the financial background and credit position of the borrower warrants the large loan, several banks may each lend a portion of the amount to the borrower. The participating banks work together in handling the loan, and work out a joint agreement as to the liquidation program of the loan, since some of the banks may wish to be paid off ahead of other banks.

PREFERRED CREDITOR–A creditor whose claim takes legal preference over the claim of another (such as Government taxes over the amount owed to an individual).

PREPAYMENT--The payment of a debt before it actually becomes due. One use of the term in banks is the prepayment penalty on mortgages, whereby the mortgagor is required to pay a penalty of 1% of the face of the mortgage when it is paid off prior to maturity. The penalty is exacted when a mortgaged home is sold during the life of a mortgage, or when a mortgage is re-financed by the mortgagor with a new mortgage. Another type of prepayment is prepaid expense. Any expense that is paid in advance, such as insurance, where the benefits of the expense develop after the expense is paid, is a prepaid expense item.

PRESENT VALUE--The discounted value of a certain sum due and payable at a certain specified future data.

PRIVATE BANK--A bank chartered by the state in which it operates, subject to state laws and regulations, and subject to examinations by the state banking authorities. The principal distinction between private banks and other state banks is that the private bank may arise from a partnership, with no capital stock. The capital is furnished by the partners who operate the business as a banking institution, performing the functions of a bank.

QUICK ASSETS

1. Those assets which, in the ordinary course of business, will be converted into cash within a reasonably short period of time (as within one year).
2. Those assets which can be readily converted into cash without appreciable loss.

RATIO--This term refers to the various analyses made by a money, or credit, lending agency of the financial statements of a given individual, company, or other business enterprise seeking credit to determine the feasibility of granting the requested credit. Some of the most common ratios used are as follows:

1. Current Assets to Current Liabilities, or Working Capital Ratio.
2. "Acid Test". The ratio that is determined by using the following formula:

$$\frac{\textbf{Cash plus Receivables plus Marketable Securities}}{\textbf{Current Liabilities}}$$

Frequently, a 1 to 1 ratio is deemed satisfactory.

3. Ratio of Notes Receivable to Accounts

Receivable. Should the financial statement disclose a large amount of notes receivable, as compared with other firms in a similar line of business, there is a possibility of a lax credit policy or the firm's extending credit to customers whose ability to pay promptly might not be too strong.

4. Ratio of Notes Payable to Accounts Payable. Three factors are frequently considered when determining whether the resulting ratio is desirable:

   (a) Notes issued in payment of merchandise.
   (b) Notes issued to banks and brokers.
   (c) Notes issued to others.

   If a relatively large amount of the outstanding notes were issued to merchandise creditors, it might indicate that the firm is unable to take advantage of the cash discounts offered in the trade and, also, that other lending agencies might consider the firm's credit not too favorably.

5. Ratio of Fixed Assets to Fixed Liabilities. This ratio tends to indicate the margin of protection to the present mortgage and bond holders, if any. If the ratio does not meet the minimum requirement, it frequently suggests that additional funds should be raised from the owners (stockholders) rather than by mortgaging fixed assets.

6. Ratio of Owned Capital to Borrowed Capital. This ratio is considered important in determining the advisability of extending additional long term credit to an applicant. If this ratio is not considered favorable, it frequently suggests that the sought funds should be raised from the owners (stockholders) of the business rather than through the additional pledging of any assets.

7. Ratio of Capital to Fixed Assets. This ratio is usually determined for a number of years to ascertain whether there is a trend toward converting the investment of the owners into fixed assets, thereby possibly relying upon creditors for furnishing the required working capital.

8. Ratio of Accounts Payable to Purchases. This ratio determined for the present period and compared with a similar ratio for previous periods will indicate the trend towards the prompt payment of current obligations.

9. Ratio of Raw Material Inventory to Cost of Manufacture. This ratio is determined by dividing the Cost of Goods Manufactured by the average Raw Material Inventory.

   The resulting figure is the number of times the investment in the Raw Material Inventory has turned over during the period under consideration. The present ratio is compared with a similar ratio for previous periods as it will tend to portray the trend and steadiness of production, or a possible over-stated or expanded inventory.

10. Ratio of Finished Goods Inventory to the Cost of Goods Sold. This ratio is determined by dividing the Cost of Goods Sold by the average Finished Goods Inventory. The resulting figure is the number of times the investment in the Finished Goods Inventory has turned over during the period under consideration. The present ratio is compared with a similar ratio for several previous periods as it will tend to portray the stability and trend of sales, or the possible over-stated or expanded inventory.

    These ratios serve as only one of the many tools used in determining the advisability of granting the requested credit and the type of credit considered best for the applicant and the lending institution. Many other factors also are given consideration, among these being the Economic Cycle or trend, the continued consumer demand for the particular product being manufactured or sold, etc.

RECEIVABLES–Accounts receivable owned by a borrower which are pledged as collateral for a loan made with the bank.

REFUNDABLE INTEREST--The return to the debtor (maker of a note) of the unearned portion of interest previously charged due to the indebtedness being liquidated prior to maturity.

RESERVE–The accounting definition for "Reserve" generally means a portion of the profits which are allocated to various reserve accounts to protect any depreciation in asset values. The reserves are taken from profits before any declaration of dividends by the board of directors. In case of a necessary depreciation in an asset account, the reserve is available to absorb this depreciation. Various types of reserve accounts are:

1. Reserve for depreciation–an "equalizing

valuation account" set up to offset an asset account in order to reduce it to its market value as its usable life diminishes.

2. Reserve for bad debts–a reserve set up to take care of possible bad debts developing in loans, "bad" checks cashed, etc.

3. Reserve for contingencies–a reserve set up for an unexpected loss that could develop, such as an unexpected lawsuit.

REVOLVING LETTER OF CREDIT–A letter of credit issued for a specific amount which renews itself for the same amount over a given period. Usually the unused renewable portion of the credit is cumulative, so long as drafts are drawn before the expiration of the credit.

RIGHTS--When a corporation increases its capital stock, it usually gives stockholders the "right" to acquire additional shares on a preferred basis. The document which designates the number of rights for shares to which a stockholder is entitled is called a subscription warrant. Since the price at which the stockholder may acquire additional shares is usually below the current market price, "Rights" sometimes have considerable value and are traded on the securities market.

SAVINGS BANK--A banking association whose purpose is to promote thrift and savings habits within a community. This organization may be either a stock organization (a bank with a capital stock structure), or a *mutual savings bank*. It usually has little or no commercial functions, but specializes in savings accounts, with an investment of these savings in long-term bonds and investments for the benefit of all the depositors.

SAVINGS AND LOAN ASSOCIATION--A financial intermediary which accepts savings from the public and invests those savings mainly in mortgage loans. Always a corporation, it may be either a mutual or a capital stock institution and may be either state-chartered or federally chartered.

SECURED LOAN–A loan which is secured by marketable securities or other marketable valuables. Secured loans may be either time or demand loans.

SELF-LIQUIDATING LOAN--A short term commercial loan, usually supported by a lien on a given product or commodities, which is liquidated from the proceeds of the sale of the product or commodities. Example: Loans granted for the growing of crops.

SINGLE NAME PAPER–A note for which only one legal entity–the maker–is obligated to make payment at maturity. A legal distinction exists in single name paper, in that if the obligation is incurred for one purpose, or one common interest, the paper may have more than one maker or endorser, and still be termed single name paper. Such a case would be two or more partners making a note for a loan to the common partnership, or a subsidiary company making a note endorsed by the parent company. Single name paper is also frequently termed "Straight Paper."

SINKING FUND–A voluntary, or contractually required, fund created by the actual setting aside from earnings a certain sum of money, for a certain number of stated periods of time, in order to accumulate a sufficient sum of money to liquidate or discharge a certain known obligation on the date of its maturity. Such a fund requirement is frequently a part of the obligation of an indebtedness, and the contract covering the indebtedness. Such contract may or may not stipulate that such periodic payments be placed in the custody of a third party known as a "Trustee."

STRAIGHT LOAN–A loan granted an individual, or other legal entity, where the basis for granting the credit is the general ability to pay unsupported by any form of collateral security.

SUBSCRIBER--One who agrees in writing to purchase a certain offering such as a certain number of shares of designated stock of a given corporation, or a certain number of bonds of a given stipulated (par) value.

SUBSCRIPTION–The offer to purchase a certain offering as a certain number of shares of stipulated stock, or bonds for a stipulated amount of money. Such offer is not binding unless accepted by the proper authorized representatives of the issuing firm or corporation.

SURETY

1. An individual who agrees, usually in writing, to be responsible for the performance of another on a contract, or for a certain debt or debts of another individual.

2. An insurance, bond, guaranty, or other security

which protects a person, corporation, or other legal entity in case of another's default in the payment of a given obligation, proper performance of a given contract, malfeasance of offices, etc.

SURPLUS–The surplus account is a part of the capital structure of a bank, and is carried in the general ledger. Before a bank can open for business as a national bank, it must have a beginning surplus equal to 20% of the paid-in capital stock. A state bank must conform to whatever the laws of the state require as pertaining to surplus. After a bank has opened, the surplus account is made up of all past earnings less the dividends declared and paid from the profits. National banks are required to carry a minimum of 10% of each previous six months' earnings to their surplus account before the Comptroller of the Currency will approve the payment of a dividend. State laws deal with surplus requirements in various ways. The surplus is a part of the net worth or ownership of the bank, and in case of liquidation, any remaining portion of surplus after all creditors have been satisfied, will be divided in the same related per cent as the capital stock held by the stockholders.

TANGIBLE ASSETS–Those assets which are of a physical and material nature (perceptible to touch) as distinguished from intangible assets which are imperceptible to touch. Examples of tangible assets are: cash, land, buildings, etc.

TERM LOAN--Usually a long-term loan with a tenure running up to ten years. These loans are made generally by the larger commercial banks and insurance companies to large, well-established business enterprises for capital expenditures such as plant improvements, purchase of equipment, etc. An amortization program is worked out in the loan agreement for the liquidation of the loan over its tenure. Generally, the amortization is moderate during the life of the loan, with a large final payment, termed a "*balloon*" payment, scheduled in the last year of the loan. The loan agreement generally calls for certain restrictions in further loan commitments by the borrower, dividends can only be paid from current earnings, and also provides that certain ratios (such as working capital ratio) be maintained at an agreed-upon level.

TIME LOAN--A loan made for a specified period of time. The maturity date generally is 30, 60, 90, or 120 days after the date of the loan. Interest is usually collected in advance, at the time the loan is made, in the form of a *discount*. This type of loan is distinguished from a "Demand Loan" in that the bank cannot demand payment at any time, but is obligated to permit the borrower the use of the money loaned until maturity of the note.

TRUST BUSINESS–A trust company, or a trust department of a bank, which settles estates, administers trusts, and performs agency functions for individuals, corporations, governments, associations, public or educational or related institutions, is said to engage in the "Trust Business."

TRUST COMPANY--An institution, usually state supervised, which engages in the trust business.

TRUST INDENTURE–An instrument in writing which contains a description of all property originally placed in the trust, the agreement as to the rights of the trustee in administering the property, the rights of all beneficiaries named, along with their proportionate share in the trust, the duration of the trusteeship, the distribution of income from the trust principal to the life-tenants, and the distribution of the trust property to the remaindermen at the termination of the trust.

UNEARNED INCREMENT--The increase in the value of property that can be attributed to changing social or economic conditions beyond the control of the title-holder as distinguished from that increase in value that can be attributed to the improvements made or additions added by the labor of the title-holder.

UNENCUMBERED--An asset owned which is free from all claims made by, or granted to, another.

UNSECURED LOAN--A loan made by a bank based upon credit information on the borrower and his integrity to repay his obligations. The loan is not secured by collateral, but is made on the signature of the borrower. A man's wife may be asked to sign the note, and the bank may also request a guarantor, if the borrower is not well known in the community.

VARIABLE RATE MORTGAGE--A mortgage contract that permits an increase or decrease in the interest rate, generally in response to changes in some specified financial indicator.

WARRANT--A form of draft which, in itself, is not negotiable, but which can be converted into a negotiable instrument. Warrants are considered "cash items" by banks. Warrants are evidences of indebtedness incurred by legal entities, and which will be duly redeemed for cash or check when presented to the drawee of the warrant. State and municipal agencies pay their indebtedness by warrants. These warrants state that the payee has performed a service for the governmental agency, that the payee is entitled to certain funds, and requests that the funds due be paid by the treasury of the governmental agency against some appropriation. The warrant, when presented, to the treasury, is paid either by check or in cash.

A claim draft on an insurance claim is a warrant issued by the insurance adjustor as evidence that the claim is valid. It authorizes the treasurer of the insurance company to pay the claim.

WARRANTS (SECURITIES)-There are several types of warrants. In general they represent the right of a holder to exchange them for cash or securities according to the purpose for which they are issued.

Dividend warrant–a document which entitles a shareholder to a specified dividend.

Interest warrant–a document authorizing payment of interest on bonds or notes to registered holder.

YIELD–The rate of return received from one's investment in a specific security, or a specific piece of property and which the record created lists both the evidence for which the indebtedness is incurred and the copy of the check showing the date, amount of payment, discount taken (if any), and the payee (seller or vendor), which discharges the debt.

WORKING CAPITAL–The excess of current assets over current liabilities representing the capital immediately available for the continued operations of the business.

WRITE-OFFS--An instrument which has been determined to be uncollectable, since there are no known visible assets available with which to liquidate the obligation. Write-offs are charged as losses to either the surplus or the undivided profits account.

Definitions in this Glossary summarized from various financial publications including the Savings and Loan League *Fact Book* and *Bank Terminology* by National Cash Register.